European Investment Bank

The EIB's role in Public-Private Partnerships (PPPs)

The document underlines that the term PPP covers a wide range of situations. From the perspective of the public sector and EIB, however, the key feature of a PPP is that it involves a risk sharing relationship between public and private promoters, based on a shared commitment to achieve a desired public policy outcome.

1. Introduction

This paper focuses primarily on:

- The lessons learned by the Bank from financing Public-Private Partnerships (PPP);
- The legislative and other policy issues that need to be addressed in developing national PPP programmes;
- The catalytic role the Bank can play in this form of private sector financing of public infrastructure services.

The document underlines that the term PPP covers a wide range of situations, and many definitions exist in the literature. From the perspective of the public sector and EIB, however, the key feature of a PPP is that it involves a risk sharing relationship between public and private promoters, based on a shared commitment to achieve a desired public policy outcome.

In this sense, 'Public-Private Partnership' is a generic term for the relationships formed between the private sector and public bodies often with the aim of introducing private sector resources and/or expertise in order to help provide and deliver public sector assets and services. The term PPP is, thus, used to describe a wide variety of working arrangements from loose, informal and strategic partnerships, to design build finance and operate (DBFO) type service contracts and formal joint venture companies.

1.1 The policy context

The European Council in October 2003 invited the Commission and the EIB to explore how best to mobilise public and private sector financing support of the Growth Initiative and how to give further consideration to a number of initiatives which should assist in the development of PPPs. The Commission, with the support of the Bank, thereafter prepared a series of measures that were incorporated into the Growth Initiative that was endorsed by the European Council in Brussels in December 2003. The proposals focused on the creation of the right regulatory, financial and administrative conditions to boost private investment as well as the mobilisation of Community funding, allied with an invitation to Member States to continue refocusing public expenditure towards growth enhancing areas without increasing public budgets.

The EIB's proposals to the Council focused on the provision of substantial additional resources both for TENs and i2i, the two key sectors covered by the Growth Initiative (see the note submitted to the Ecofin Council of 25 November 2003 – CA Document 03/515). Specifically, EIB undertook to use its best endeavours to expand the range of financial instruments used, including particularly financing for PPPs, in support of these two key sectors. Equally importantly, EIB undertook to develop its institutional links with the Commission; with Member States; with specialist financial institutions (including National PPP Task Forces) as well as with the banking and capital markets in support of increased private and public sector financing of these high priority sectors.

The EIB's commitments made under the Growth Initiative were a natural evolution and step up of measures already taken by the Bank over the previous 10 years to encourage greater private sector financing of public infrastructure. This paper, therefore, provides an overview of the role being played by PPPs in Europe and the contribution of the EIB to the development of PPPs, both as a contribution to the achievement of economic objectives and as a financial instrument.

1.2 The content of this paper

Section 2 summarises the general development to date of PPPs in EU-25, noting the characteristics that distinguish PPPs from 'conventional' procurements. It also sets out the main factors that are driving increased use of this mechanism. In this context, the role of PPPs in improving Value For Money for the public sector in the delivery of public infrastructure is paramount.

Section 3 examines the main principles that have governed EIB's involvement in PPPs; a summary analysis of the Bank's exposure to PPPs is also provided.

Section 4 sets out some of the main lessons that have been learned in relation to the operation and management of PPP programmes by the public sector and the added value EIB can bring to these operations. This section also discusses the sectoral concentration of PPPs. Annex 3 to this paper deals with health sector PPPs throughout the EU.

Section 5 reviews the various constructive steps taken by the Commission and other EU Institutions to facilitate the further development of PPPs, including the recent Green Paper (consultation document) on procurement rules as they apply to PPPs and the Eurostat decision on Public Sector Accounting Treatment of PPPs.

Section 6 summarises the priorities for the Bank both through its financing of PPPs, and its wider role of sharing experience of PPPs across Europe.

2. The development of PPPs in Europe

2.1 The characteristics of PPPs

The term "Public-Private Partnership" (PPP) has been in general use since the 1990's; there is, however, no single European model of a PPP. This is a distinct strength as it reflects the wide diversity of practice that has developed to facilitate private sector participation in the provision of public infrastructure. Diversity is also natural; although some features of PPPs may be distinctively new, it should be recognised that the private sector has participated, and still participates, under many different corporate and legal forms within EU countries in the provision of public infrastructure. It is therefore unlikely, and not necessarily desirable, that all such forms of private sector participation should be reduced to one corporate or legal template. Indeed, before the term PPP became current, continental Europe had a long experience of risk sharing concession structures (some of which have been financed by EIB) with the characteristics of PPPs. In Spain, for example, the first concessions of this type have now run their concession periods and are being handed back to the public sector; other continental countries also have a strong tradition in public sector concessions to the private sector.

Provision of new investment in infrastructure in Europe is increasingly being carried out under a range of PPP structures based on the principle of private sector risk taking participation in the provision of public infrastructure. Such projects may involve private sector capital expenditure on new assets, or upgrading of existing ones. Typical examples of such public infrastructure are airports, railways, roads, bridges, tunnels, environmental facilities (such as waste incinerators and water treatment plants) and public buildings including government offices, schools, hospitals and prisons. Although provision of public infrastructure does not necessarily require that it will be financed, operated or maintained in the long term, this is characteristically part of a PPP.

The role of the private sector in public infrastructure provision is, for reasons of history as well as public policy, more widely developed in some countries than others. Annexes 1 and 2 illustrate the extent to which PPP programmes, legal systems and government organisations have been, or are being, developed both within EU-25, and in the Applicant Countries. Some of the main factors that facilitate (or inhibit) the development of PPP programmes are discussed in section 2.2.

The core objective for the public sector of a PPP programme is to harness private sector skills in support of improved public sector services. This is achieved by moving away from the direct procurement by the public sector of physical assets and towards the procurement of services from the private sector under public sector regulation/contract. In the context of infrastructure projects, PPPs are therefore often characterised by the public sector:

- Entering into contracts to acquire services, rather than procuring an asset;
- Specifying the service requirement on the basis of outputs, not inputs;
- Linking payments to the private sector to the level and quality services actually delivered;
- Often requiring a 'whole life' approach to the design, building and operation of project assets;
- Seeking optimal risk transfer to the private sector, based on the principle that risks should be managed by the party to a transaction best able to manage the relevant risk;
- Requiring the private partner to be responsible for raising some or all of the investment finance required for the project;
- Utilising diverse payment mechanisms, such as market revenue, shadow tolls, capacity availability payments and so on.

2.2 Drivers for PPP developments in Europe

PPP structures with the characteristics described above are becoming increasingly important means of delivering infrastructure developments across Europe. Why is this?

The principal policy imperative at Member State level is the increased, and increasing, emphasis on improving the efficiency and quality of public services. Indeed, the most important driver for PPP development is the increasing recognition of the role the private sector can play in achieving the objective of improved quantity and quality of public services. PPPs offer the opportunity to capture private sector efficiencies and introduce appropriate risk sharing mechanisms between the public and private sector. The ability to transfer and ultimately align risks and rewards within project structures has proved critical to the ability of PPPs to deliver improved Value For Money to the public sector. This has encouraged many governments, as well as the European Commission, to seek to ensure that an appropriate regulatory environment, and legal framework, designed to support the increased involvement of the private sector in public service delivery is put in place.

In a parallel fashion, the development of the Single Market has facilitated international procurement and competition between infrastructure companies. Alongside reforms to public procurement rules, this has enabled the private sector to respond positively to these new opportunities to become involved in the delivery and operation of public infrastructure across many EU countries. The development of the Euro market that brought about convergence as well as substantial reductions in long term interest rates in a number of Euro zone countries also had a material effect on the viability and financeability of infrastructure financed by the private sector. It also significantly increased the maturity and liquidity of financial instruments available for infrastructure financing, an evolution that is still underway both in GBP and Euro markets.

Indeed, the availability of contractor, and investor, capacity is a key requirement for effective PPPs. There is growing evidence that this capacity is applied across national borders. In addition, PPP structures have enabled new players to enter the market, often as part of a joint venture. This also gives smaller private companies (including SMEs) the ability to participate in large scale projects (and to access long term finance) in a way that would have been problematic in conventional private sector 'balance sheet financed' procurements. This opening up of the market generates competitive pressure that ultimately works to the benefit of the public sector.

The improvement of public services can also require increased levels of investment that have become more difficult to source from traditional budgetary means in a tight fiscal environment following the development of European Monetary Union. Although PPP financing can be, and has been, economically beneficial to governments with fiscal surpluses as well as with fiscal deficits, PPPs can be a way to accelerate the implementation of economically viable projects when the transfer of risks to the private sector, determined on the basis of Value For Money considerations, is substantial enough to justify proceeding with projects that would not have been financeable under classical procurement. Given that many such projects are classified as 'on balance sheet' for government deficit accounting purposes under ESA 95 guidelines (for example, in the UK approximately 60% of all PPP transactions are accounted for 'on balance sheet'), the question of government accounting treatment is but one of the many factors that may be taken into account by governments in their decisions to authorise an overall PPP programme and it is certainly not the most important (see section 5.2).

2.3 PPPs and Value For Money (VFM).

The key consideration for governments in launching a PPP programme should be ensuring Value For Money (VFM). PPP structures offer a number of key advantages that can enable them to deliver Value For Money to the public sector in infrastructure projects. First, PPPs facilitate (and create incentives for) on-time and on-budget project implementation. The 'no service / no pay' principle ensures that the private partner is incentivised for timely delivery and operation of project assets. Control on cost overruns is often improved by better overall governance. Traditional public procurements are in certain countries, in contrast, often characterised by significant construction delays and cost overruns. Related to this, where life cycle maintenance obligations fall to the private sector, operators are incentivised to optimise capital and maintenance spends over the project duration. The private partner is further encouraged to find innovative means to manage the operational risks that go with the project. As a general principle, by transferring risks to those best able to manage them, the overall cost of risk in a project is reduced. This reduced cost of risk is the key means of delivering Value For Money to the public sector, and in successful PPPs more than offsets any higher cost of finance from private vis a vis public borrowing.

The value to the public sector of risk transfer needs to be demonstrated on a 'case by case' basis in each project in accordance with an agreed methodology generally referred to as a Public Sector Comparator (PSC). In other words, the public sector needs to be able to satisfy itself that the price it is paying a private partner to invest and assume project risks gives good value to taxpayers. The Value For Money calculation therefore must take into account that the price charged by the private sector will include the requirement for a return on capital appropriate to the level of risk being assumed.

It is not, therefore, automatic that PPPs and attendant risk transfer will prove better value for public money than conventional procurements; nor indeed that the PPP will necessarily complete major infrastructure more quickly than traditional procurement as PPP projects normally take longer to prepare due to their complexity. Achieving the optimal allocation of risk is the most important single factor in structuring a PPP. However, achieving Value For Money requires a number of other conditions also to be fulfilled. These include the appropriate selection of projects (a PPP will never cure a weak project), a clear and stable legal framework, skilled and experienced people in the public sector, and experienced and creditworthy private sector partners. Mechanisms for the diffusion of best practice such as the creation of PPP Task Forces and specialised units and the use of widely agreed benchmarking tools to measure Value For Money can also be extremely helpful.

2.4 The pattern of PPP developments in Europe

The development of PPPs in Europe has been sectorally concentrated, see Annex 1, with the principal areas of activity being in the transport sector (road, rail, estuarial crossings) as well as education and health. These are the sectors in which the greatest degree of practical experience has been developed. Other sectors such as waste, environment, ports, energy and social housing are also undergoing extensive development, but have not yet the level of 'critical mass' in terms of numbers of projects that is necessary for a fully competitive market to emerge.

Geographically, the PPP market has also been somewhat concentrated. The 'first movers' in this market were the UK, followed closely by Portugal, Spain, Greece, the Netherlands, Denmark and Sweden though the extent of their programmes varied substantially. Further significant developments are now underway through the PPP programmes in Ireland, Italy, France and Germany. Extensive consideration was also given during the 1990's in many Central and Eastern European countries to the development of PPP programmes. These initiatives were largely unsuccessful initially; they are now being re-examined and redeveloped in the light of that experience.

The UK has Europe's largest programme of PPPs (covering all major civil procurement sectors); over 650 projects have been procured as PPPs, of which over 400 are already in operation. The total capital expenditure on PPPs to date is approximately GBP 48 billion, which is on an annual basis the equivalent of 12% of the UK government's capital expenditure budget. The UK PPP market represents around 25% of the overall EU PPP market at present, however many other countries have extensive and growing programmes. Portugal has a wide ranging PPP initiative, which although focussed initially on road, rail and energy is now beginning to encompass the health sector (see Annex 3). In Greece, major infrastructure projects such as the Athens international airport at Spata, the Rion Antirion Bridge and the Essi motorway (Athens ring road), have been implemented on a PPP basis and the Greek national programme has been subsequently expanded to cover the extension of the country's motorway network through the use of PPP type financing structures. In the Netherlands the national PPP programme is being applied to a number of sectors; having started with transport projects such as high speed rail, roads and estuarial crossings, the programme has now been extended to education and justice. One of its "flagship" PPP projects is the High-Speed Rail link between Amsterdam, Schiphol and Rotterdam to the Belgian border linking the Netherlands to the PBKAL High Speed Rail Network (Paris, Brussels, Cologne, Amsterdam and London). Ireland has initiated an ambitious programme of PPP roads and schools. Italy has considerable experience of PPP power projects and, like Portugal, is extending its PPP programme into the healthcare sector. Indeed, the Italian government has introduced legislation (the 'Merloni' laws) to support an ambitious PPP programme, focusing primarily on transport, water and health. Spain has undertaken many PPPs in the urban transport and roads sectors and the national roads concession legislation was updated in 2003 to encourage further private investment in the sector (and, in particular, to stimulate capital market funding). A PPP programme in the hospital sector has recently been announced. The German government is also adopting PPP structures for its road tolling systems. The French government is about to modernise the existing legal framework extensively used in the past to implement private or mixed concessions (for example, for transport, water and urban services). Appendix 2 provides a schematic summary of the legislative position in EU and candidate countries.

Experience to date suggests two important conclusions. First, most countries commence PPP procurements in the transport sector, but then develop into other sectors as the 'Value For Money' benefits of PPP procurements are proven and as public sector expertise in PPP procurement is established. Secondly, the PPP structures which emerge from these developments demonstrate considerable national variation.

Indeed, it is clear that PPP techniques succeed *because* they can be adaptable to the specific financial circumstances of each project and to the broad political conditions and socio-economic priorities of each country. This is one of the inherent strengths of the PPP approach, a key attraction for the public sector and a basis for ensuring broad public support.

3. EIB involvement in PPPs

3.1 Financing principles

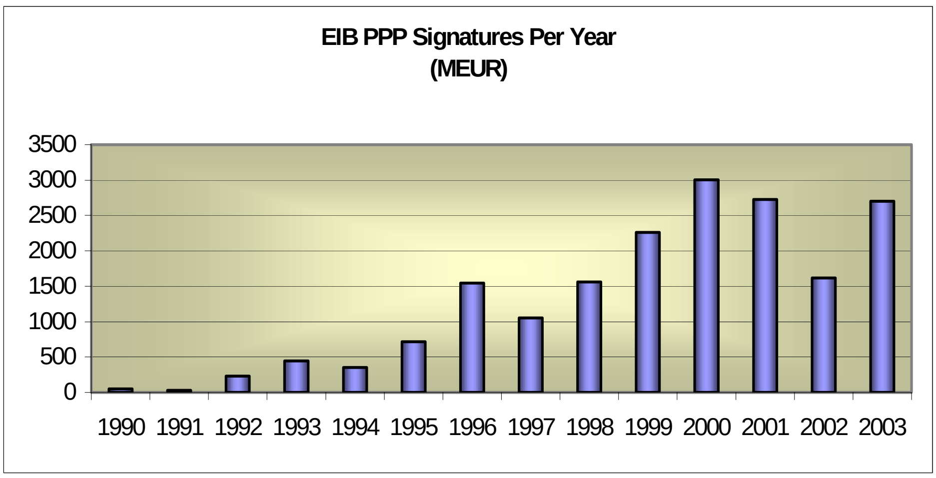
Against this background, EIB's role is to support this increasing drive in Member States towards the improvement of public services through increased private sector participation, structuring its own participation in PPP projects in ways that optimise the ability of the public sector to meet EU policy objectives.

A number of fundamental principles underlie the EIB's approach to PPP projects. These have been designed to achieve the overall policy objectives, whilst promoting competition *and* ensuring that the benefits of EIB involvement are, to the maximum possible extent, passed to the public sector.

First and foremost, the Bank requires that all PPP projects supported by it are financially robust, economically and technically viable, meet the Bank's environmental requirements and are competitively tendered in accordance with EU procurement rules (see section 4.2). The Bank applies the same criterion of Value Added to PPP financings as to all other sectors. Wherever possible, EIB becomes involved in projects at an early stage, prior to commencement of procurement, with the Bank working on a non-exclusive basis with all bidders (subject to their technical capacity and financial standing) during the bidding phase. This ensures that bidders compete *inter alia* on the extent to which they pass the financial benefits of EIB participation on to the public sector.

The Bank's principle of providing complementarity with other funders (both commercial banks and the capital markets) is maintained in PPP structures – the extent of funding provided by the Bank remains within the usual limits. Many EIB loans to PPP projects are either bank guaranteed or monoline insured whether to maturity, or with release once the project has a proven operating record. However, in some cases (operations under the Structured Finance Facility) EIB relies exclusively on project security from the outset. As a matter of policy, the Bank remains conservative in applying credit tests to all PPPs, for example, through the requirement for concession periods to have a robust "tail" beyond the maturity of the Bank's loan, through the use of cover ratios as credit criteria and so on.

The credit quality of the Bank's PPP portfolio is underpinned by the public sector support for the payment streams to many PPP projects. Indeed, in many projects (such as the UK PPP hospitals and schools), payment obligations lie solely with the public sector and concessionaires are not subject to any form of 'demand risk'. PPPs also typically benefit from strong regulatory and contractual frameworks. The EIB portfolio is also diversified and much has recourse to solid forms of credit enhancement (such as bank guarantees during the construction phase). Finally, although the volume of PPP activity has increased (see chart below), the loan amounts involved remain relatively limited compared to overall lending volumes. On these bases, it can be concluded that the PPP portfolio does not raise at present concerns in terms of concentration.



3.2 The Bank's exposure to PPPs

In 2003 the Bank provided debt financing of a total of EUR 2.7bn to 17 new PPP projects. On a portfolio basis, this took EIB's overall nominal and risk weighted exposure to PPPs to EUR 14.7bn and EUR 5.9bn, respectively. The largest exposure in the PPP portfolio lies with road/motorway projects, tunnels and bridges and urban development/transport projects accounting for 39%, 22% and 17% of overall PPP portfolio, respectively (see Table 1 below).

Table 1 : Exposure to PPP Projects by Sector

Sector	Exposure Signed (nominal) (EUR m)	% of total	Median Loan Maturity
Roads and Motorways	5,701	39%	25
Tunnels and Bridges	3,228	22%	21
Urban Development, Renovation and Transport	2,538	17%	26
Airports	997	7%	19
Traditional and High Speed Trains	936	6%	20
Social Infrastructure (Education and Health)	819	5%	29
Drinking and Water, Water Treatment	265	2%	19
Power Generation, Transmission and Distribution	237	2%	13
Total	14,721	100%	

In terms of country exposure, the UK, Portugal, Spain, Greece and Denmark each account for more than 10% of nominal exposure (Table 2). Risk weighted exposure is currently concentrated in the UK, Portugal and Spain. The UK exposure is diversified over a wide portfolio.

Table 2 : Exposure to PPP Projects by Country

Country	Exposure Signed (nominal) (EUR m)	% of total
Austria	40	0.27%
Denmark	1,532	10.41%
Germany	682	4.63%
Greece	2,150	14.61%
Ireland	146	0.99%
Netherlands	525	3.57%
Poland	315	2.14%
Portugal	2,804	19.05%
Spain	2,618	17.79%
Sweden	311	2.11%
United Kingdom	3,598	24.44%
Total	14,721	100%

3.3 Loan maturities

Loans to PPPs are characterised by long amortising maturities that reflect the extended technical and economic lives of the project assets and the underlying concession durations. As of 31 December 2003, 83% of PPP exposures related to loans with maturities of 20 years and above. The longest loan maturities are found in social infrastructure (principally hospitals which are characterised by long economic lives and strong public sector covenants) and the urban development and local transport sectors where loan tenors typically range between 25 and 30 years. A breakdown of the portfolio by loan maturity is provided in the Table 3.

Table 3 : Exposure to PPP Projects by Loan Maturity

Loan Maturity	Exposure Signed (nominal) (EUR m)	% of total
Up to 19 years	2,490	17%
20 – 25 years	8,580	58%
26 – 30 years	3,339	23%
Over 30 years	312	2%
Total	14,721	100%

An analysis of future exposures (i.e. loans which have been approved but not yet signed) shows a trend towards an increase in loan maturities for PPP projects. Nearly 30% of such future exposures have amortising maturities in excess of 30 years.

The characteristics of PPP projects (extended asset lives; substantial public sector underpinning and/or regulation of the PPP cashflows; strategic public assets; substantial security structures, including third party guarantee or insurance to maturity or release after the project has a proven operating record as well as adequate contractual protections to allow the management of risks over the long term) are believed to adequately support such long maturities. It is also to be noted that such extended terms are becoming the norm required by the public sector, reflecting the need for loans to match, even if conservatively, PPP projects' revenue profiles.

4. Lessons learned from the Bank's experience of PPPs

This section summarises some of the key lessons the Bank has learned from its involvement in PPP projects.

4.1 The selection, appraisal and monitoring of PPP projects

Experience has shown the benefits of early dialogue between the Bank and relevant public authorities to identify the most suitable projects (and those with most chance of success). This enables the Bank to concentrate its resources on those projects with the highest policy significance for national administrations, and those which are best aligned with the EIB Corporate Operational Plan. In practice, the Bank has decided, and been able, to focus much of its PPP activity on priority sectors (TENs, education and i2i, health) and in regional development areas.

PPPs have made additional demands on the Bank's appraisal, structuring and negotiating capacity. The appraisal of risks requires close working between all parts of the Bank's operational services, often incorporating *inter alia* review of promoters' technical and market studies, review of technical and market analyses carried out for lenders, in-house assessments of risk and in-depth analysis of the technical aspects of concession, construction and other project contracts. Legal, commercial and technical due diligence is also required to cover the project's public sector counterpart, the financial standing of the concessionaire, the review of the concession main terms and conditions and other financial and project contractual documentation.

Similarly, PPP projects' complex contractual and financial structures require more active and increasingly specialized monitoring, in particular for those projects where EIB relies only on single asset revenue and cash flow for the service of its debt (e.g., SFF transactions and bank guaranteed loans with release).

The demands on resources for appraisal, due diligence, structuring, negotiation and monitoring are, therefore, significant. For this reason, the Bank seeks to ensure that the costs incurred are reflected in the pricing and cost recovery arrangements negotiated with borrowers.

4.2 Procurement issues

Appropriate, competitive procurement is one of the key conditions for success of a PPP. The tendering process can be a complex exercise, requiring highly skilled people on both public and private sides. In some cases, the development of a PPP can involve long and costly negotiations; in other cases (often in countries with experience of concessions) it may be possible to simplify procurement whilst retaining competitive pressures.

Review of the procurement procedure is an essential part of EIB due diligence on PPP projects. Both formal (compliance with EU legislation and, outside EU, with EIB procurement rules) and substantial (competitiveness of the tender process and benefits to the public sector) aspects are thoroughly analysed, with in almost all cases an increasing degree of involvement of the Bank during the procurement phase (see section 3.1). The Bank also acts more upstream as an advisor to public authorities, Member and Acceding States and other EU institutions on general procurement issues.

4.3 Performance of PPP projects

National audit authorities have given particular attention to the performance of, as well as Value For Money (VFM) from many PPP projects financed in their respective areas of responsibility. These extensive reports from different, independent bodies throughout the EU are a most valuable source of information and benchmarking. In particular, they contribute to the wide diffusion of information about the possible performance levels that can be achieved, and PPP features that worked, as well as those to be avoided. Annex 4 presents extracts from reports from the UK National Audit Office. These indicate that the performance of UK PPP projects has been generally good particularly in respect of cost and time performances on major infrastructure, albeit with some weaknesses in the early schools projects; they have also been most helpful in pointing out difficulties or errors made, notably in the IT sector which has generally proven an unsatisfactory sector to date for PPPs. Similar reports are also available from other national audit bodies; the recent – and critical – report of the Portuguese Tribunal de Contas on the SCUT programme is a relevant example.

EIB's overall experience is that the performance of the projects it has financed has been good. In terms of construction, projects have generally been completed by the target completion dates set out in the project contracts. Within the portfolio, just one project has fallen significantly behind schedule. Although in this case the Bank is guaranteed and therefore at no direct credit risk, EIB has worked with other senior lenders to help put in place remedial measures. Many other projects have experienced minor, and not unusual, contractual disputes during the construction phase. In some cases these disputes (usually relating to so called 'snagging' items) have been carried over to, and been resolved in, the early operational phase.

In general, projects have achieved anticipated levels of operational performance within six to twelve months of the commencement of operations. During this period, limited payment deductions are the norm – most of these relate to the resolution of 'snagging' items. Beyond the 'bedding down' period, projects have generated stable and acceptable cashflows. Release and refinancing tests applicable to EIB projects have normally been met at the appropriate time.

4.4 Sectoral focus

As indicated above, it is a consistent observation that the initial focus of PPP procurement in most countries is on the transport sector. Thereafter, countries often make a progressive migration towards other sectors (such as education, health, energy, water and waste treatment) where the techniques of PPP procurement are being seen to be equally valuable.

The extent and pace of this migration reflects both national political priorities and national legal frameworks. For example, the UK has placed considerable emphasis on the importance of PPP structures in the social sectors of education and health. The government has concluded that PPPs have the predominant role to play in its current hospital investment programme – the largest in the history of the National Health Service. Since 1997, 64 PPP hospital projects with a capital value of GBP 11.1 billion (EUR 15.7bn) have been approved by the Department of Health in England to commence procurement. Of these, 27 schemes with a value of GBP 3 billion (EUR 4.3bn) have been completed and are operational, or are in construction. In the same period, only four directly publicly funded schemes with a value of GBP 0.2 billion (EUR 0.28bn) have been approved. Annex 3 provides a more detailed analysis of the health sector PPPs financed by EIB to date.

This choice in the UK reflects both the scale of, and the priority attached to, the current hospital development programme. However, it also reflects a highly supportive legal framework. At least three other countries in Europe (Portugal, Spain and Italy) are now bringing forward substantial PPP programmes in the health sector.

It is also notable that national PPP programmes often commence with relatively large, central government promoted projects, with subsequent development of smaller (sometimes repetitive) projects at local or regional government level.

4.5 The diversity of payment mechanisms in PPP structures

There is considerable diversity in the structuring of payment mechanisms for PPP projects in the EIB's portfolio, reflecting the diversity of PPP structures in Europe. The inherent flexibility of PPPs, and of the risk management arrangements within these, enables projects to be optimally structured to take account of the objectives of the public sector. A particular example is the use of tolls and availability based payments in road projects. Where the public sector has the objective to pass all, or a proportion, of the costs of a new road to direct users, user tolls will be the optimal payment mechanism. In contrast, where the principal policy objective is to reduce road congestion, availability based payments may be preferred. In this case concessionaires are incentivised to maximise availability – and reduce congestion – by, for example, off peak scheduling of maintenance works, effective responses to extreme weather and so on. In some cases, concessionaires have been directly incentivised to improve safety (through effective maintenance, improved lighting and so on) by means of payments related to accident rates. In practice, the Bank has noted a general tendency for the public sector to move from toll based to availability based payments in transport PPPs, however, the ability to use the different payment mechanisms inherent in PPP structures to achieve differing policy objectives and optimise risk sharing is a key characteristics and strength of the PPP.

4.6 Issues of scale and expertise in PPP programmes

Although the benefits of PPP projects can be considerable, the demands PPP procurements place on the public and private sectors can also be significant. The public sector needs new skills (not only the negotiation of contracts but also relating to the specification of services in a way that makes them suitable for a PPP contract) and the private sector may have to incur additional tendering and negotiation costs. These factors imply that PPP programmes need to be focused on specific sectors for the initial period as well as be of a minimum scale – both in terms of the size of individual projects and the number of projects in a national programme to ensure that there is sufficient "deal flow" to support effective competition by the private sector.

The costs associated with procurement can be reduced over time, after the necessary learning curve effect, by an appropriate legal framework (which, for example, allows for the use of standardised contractual documentation, is flexible with respect to procurement timetables and the services to be tendered and so on). It is also important that the public sector should have some degree of central management over the timing of PPP procurements. In particular, procurements may need to be planned to ensure that competitive pressures amongst bidders can be maximised. This raises the more general issue of the difficulties which will be faced by countries where there may be insufficient local competition in the provision of services (or, indeed, where there is no local capacity within the private sector for provision of services which might be incorporated in a PPP).

The general principle that national PPP programmes often start with relatively large national projects, promoted by central government, is noted above. This can prove an effective way of building expertise within the public sector (for example, in a National PPP Task Force) and avoid the costs of repeated 're-inventing of the wheel' at local level. These Task Forces can have a key role in spreading the lessons learned from successful procurements throughout the public sector. More generally, where there is no appropriate National PPP Task Force to support and drive VFM for PPP procurements (or indeed where the interest in PPP procurement is principally driven by budgetary as opposed to Value For Money considerations), it is highly unlikely that PPPs will achieve their potential.

Given the willingness of the EU Commission to use structural/cohesion funds to part-finance the public sector contribution in appropriate cases in the new Member States, collaboration of the work of National Task Forces with DG Regio and other Commission services is also highly desirable. Amongst the roles that DG Regio and the Commission could play is the provision of financial support to Task Forces in countries establishing their PPP programmes to build the necessary institutional capacity to support the development of PPPs. In such circumstances, the Bank could also consider the provision of development assistance (in the form of staff expertise) to help create the necessary momentum for viable PPP programmes and through the provision of financing for viable flagship PPP projects capable of creating appropriate templates for the general development of PPPs in different sectors.

4.7 Value added of EIB funding in PPPs

EIB has brought significant added value to the PPPs it has financed. From a financial perspective, the long loan maturities and capital grace periods offered by the Bank are particularly appropriate for major infrastructure given the long economic lives of the assets being financed and the typical evolution of cash flows over the project life. These improve affordability of the investment for the public sector as well as contributing to the financial robustness of the arrangements put in place. Furthermore, the cost of EIB funds enhances public sector Value For Money from these deals. By strengthening the economics of projects, these features also benefit other participating financiers.

In most PPPs there should be a strong identity of interest between the financiers and the public sector counterpart if the partnership is to be successful. Both require the project to meet its performance objectives and, for this reason, the public sector will normally look to financiers to carry out thorough and independent due diligence on potential projects, as well as to ensure subsequently that operational problems within projects are satisfactorily resolved either by the concessionaire or by themselves. In this context, the EIB's high standard of due diligence, as well as its commitment to holding project debt until maturity (i.e. no selling down or syndication of debt which is common amongst other senior lenders), offers considerable stability, robustness, experience and added value to the public sector.

The Bank's ability to undertake upstream advisory work with public sector bodies on the development of PPP programmes or on individual priority flagship projects, either directly or indirectly (for example, through sharing or experience or secondments), has also been highly valued by the public sector where this has been done to date. This has happened both with national bodies as well as with smaller regional or municipal administrations with limited or no PPP experience. The EIB's ability to assist in the bankable structuring of flagship PPP projects has been an important factor in accelerating the process of closing deals (and has increased Value For Money for the public sector).

Related to this, the Bank's participation in a project, given its unique status as an 'impartial' not for profit financier with a public policy mission and considerable technical expertise, can have an important effect in building confidence between the public and private parties to a transaction. One example of the Bank's catalytic influence is the Tagus Bridge project, the flagship project of the Portuguese PPP programme, where this role has been particularly recognised.

Finally, EIB has also been able to develop innovative and flexible financing structures for PPP projects. In addition to 'traditional' fixed and floating rate loans, the EIB developed the Bank's first index linked funding product for its PPP operations. The Bank has also made use of the Structured Finance Facility for high priority PPP projects. As set out in the Growth Initiative, the Bank is also working on the further development of an extended range of financial instruments such as Guarantees; Junior and Mezzanine Debt; Infrastructure Funds and extending its use of Securitisation as appropriate to facilitate the increased participation of the private sector in the provision of public infrastructure. These innovations, along with the value attached by other lenders to the Bank's due diligence, are contributing to the Bank's role as a catalyst for other sources of funding.

5. EU Institutional Developments on PPPs

As part of the Growth Initiative, the European Council has approved a series of measures designed to increase investment in the infrastructure of the trans-European transport network and also in the fields of innovation, research and development, mainly through forms of PPPs. This welcome initiative to support the development of PPPs is but one of a series taken by the Commission in recent years in pursuit of their objectives of improving EU growth and competitiveness. The initial such proposal was developed in the Kinnock Report of 1997 on PPP financing of TEN-T projects[1].

5.1 EU Procurement Legislation

The Commission has already taken a number of distinct and constructive initiatives under public procurement law to clarify the legal framework for PPPs. In 2000 it published an Interpretive Communication[2] on concessions and Community public procurement law in which it defined, on the basis of the rules and principles derived from the Treaty and applicable secondary legislation, the outlines of the concept of concession in Community law and the obligations incumbent on the public authorities when

[1] COM (1997) 453
[2] COM (2000) 5

selecting the economic operators to whom the concessions are granted. In addition, the new Directives of the European Parliament and the Council, adopted in February 2004, and designed to modernise and simplify the Community legislative framework, established an innovative and new award procedure (referred to as "competitive dialogue"). This was designed principally to meet the specific features of the award of "particularly complex contracts", and thereby certain forms of PPPs. This new procedure allows the public authorities to hold discussions with the applicant businesses in order to identify the solutions best suited to their needs.

Nevertheless, many representatives of interested groups consider that the Community rules applicable to the choice of businesses called on to cooperate with a public authority under a PPP, and their impact on the contractual relationships governing the execution of the partnership, are still insufficiently clear and lack homogeneity between the different Member States. Such a situation can create a degree of uncertainty for Community players that is likely to represent a genuine obstacle to the creation or success of PPPs, to the detriment of the financing of major infrastructure projects and the development of quality public services.

In view of this, and to help address these concerns, the Commission has now issued a Green Paper, an EU consultative paper, on PPPs and Community law on Public Contracts and Concessions[3]. The intention is to ensure that the development of PPPs can be facilitated under conditions of effective competition and legal clarity. Amongst other issues, the Commission is seeking views on the impact of the new "Competitive Dialogue" procurement procedure on PPP transactions[4]. The consultation is also seeking views on the treatment of 'step in' type arrangements where lenders may have the right to replace poorly performing concession companies and the procurement treatment of the opportunities that have been developed in some Member States for the private sector to take the initiative for formulating proposals for a PPP project. In certain Member States, the private initiative is subject to specific supervision (see, in Italy, the Merloni law of 18 November 1998 and, in Spain, the regulation on local authority services of 1955 and the law 13/2003 on works concessions of 23 May 2003). In other Member States, the private initiative PPP is also emerging in practice.

The aim of this Green Paper is to launch a debate that will lead to a clearer framework for the application of Community law on public contracts and concessions to PPPs. This framework will concentrate on the rules that a public service should apply when taking a decision to entrust a mission or task to a third party. This takes place downstream of the economic and organisational choice made by a local or national authority, and is not an attempt to make a value judgement regarding the decision to externalise the management of public services or not; this decision remains squarely within the competence of public authorities. Indeed, Community law on public contracts and concessions, as well as EIB's own policy in practice, is neutral as regards the choice exercised by Member States to provide a public service themselves or to entrust it to a third party. The Bank will respond formally to the consultation in due course.

5.2 Accounting and Statistical Rules for PPPs

The European Commission undertook to the European Council on the Growth Initiative that Eurostat would publish a clarification of the ESA 95 rules on Government Deficit accounting in so far as they apply to PPPs. Uncertainty in the area of interpretation of PPPs in the European system of accounts has been high on the list of concerns of governments seeking to develop PPP programmes both amongst new Member States and the EU 15. Although "off balance sheet" accounting is not, and should not be, a primary driver for procuring PPPs, continued uncertainty in this area was a cause for concern and was unhelpful to both the public and private sectors as governments sought to respect the Maastricht criteria.

In February 2004 the CFMB and Eurostat published their proposals on the accounting treatment for PPPs[5]. The guidance published set criteria to enable governments to decide whether or not a project would be considered as being a public sector obligation for the purpose of the deficit procedure or would be considered off balance sheet.

[3] COM (2004) 327 Green Paper on Public-Private Partnerships and Community Law on Public Contracts and Concessions

[4] Directive 2004/18/EC. This procedure believed by the Commission to be particularly appropriate to some complex PPP contracts. It is launched in cases where a contracting body is objectively unable to define in advance the technical means that would best satisfy its objectives, or where it is objectively unable to define the legal or financial form of a project. Candidates will be invited to enter into dialogue, and submit final tenders on the basis of the solutions identified in this dialogue.

[5] (FTAT /04/18) 2004

Eurostat recommended that assets involved in a PPP should only be classified as non-government assets, and therefore be recorded off the balance sheet of the government, if both the following conditions are met

i) the private partner bears the construction risk; and
ii) the private partner bears at least one of either availability or demand risk.

A summary of the Eurostat paper is attached as Annex 5.

5.3 Combining EU Funding with PPPs

EIB's experience has shown that EIB loan funding can be successfully combined with either public or private sector funding in a wide range of PPPs. EIB funding has also been combined successfully with ERDF/Cohesion grants throughout the EU.

Considerable uncertainty has however been expressed as to whether, and how, EU grant funding can be used to co-finance PPP projects. The Commission took helpful steps in 2003 by publishing guidelines for successful Public Private Partnerships that aimed, amongst other things, to seek to address how EU grant funds could be integrated into PPPs, particularly in the new Member States. EIB will continue to work closely with the new Member States and the Commission to seek to ensure that optimum use of Community resources can be achieved in the PPP sector.

6. Conclusion

The Bank's involvement in PPPs is playing a key role in supporting a drive in many Member States towards improvement in public services where these Member States wish to achieve this through increased private sector participation. Much of this drive is occurring in sectors and areas of critical policy significance, and key COP priorities such as:

- TENs and the modernisation of transport infrastructure;
- School and university education;
- Primary and secondary healthcare; and
- Environmental improvement.

The focus of the Bank's lending activities to PPPs, therefore, strongly underpins EIB's role as a public sector, policy driven bank. In addition, to EIB's direct lending activities, the Bank also plays an important wider role, reflecting EIB's unique position as a major pan European player in the PPP market and as a catalyst for PPPs. This is achieved through the Bank's close cooperation with the public and private sectors in facilitating private sector infrastructure investment and through the introduction of an extended range of new financial products to support those objectives. The Bank will continue to work closely with project promoters; the commercial banks; the capital markets as well as act as an advisor to public authorities, Member and Applicant States and other EU institutions. EIB's willingness and ability to share its extensive experience of PPPs from a wide range of countries and sectors, and to bring to bear multi-sectoral know-how, demonstrates how EIB can contribute to meeting its various priority objectives while adding value through utilising its knowledge and experience.

The Bank keeps its PPP portfolio under careful review and on going monitoring, often in conjunction with other funders, is an important aspect of EIB's PPP related work. This monitoring activity is not only of significance in terms of maintaining the quality of the portfolio – it is also significant for the public sector, which shares a clear interest with lenders in the successful implementation of projects.

It should be stressed, however, that the Bank has no policy preference for PPPs, as opposed to other forms of procurement. It is a matter of choice by the Member States whether they pursue traditional or other forms of procurement including PPPs. EIB is prepared to work closely with Member States, through its financing and the sharing of its knowledge and experience, to achieve national and EU policy objectives and to add value in whatever ways are appropriate within the overall policy framework.

EIB will continue, as already outlined in the Growth Initiative proposals, to improve the general understanding and knowledge of PPPs so that the public authorities can benefit from EIB's extensive experience in this domain and to enable them, where appropriate, to develop necessary policy frameworks, institutional capacity and pilot project programmes for the fulfilment of their objectives.

Annex 1: Summary of PPPs by country and sector

	Roads & Bridges	Light Railway	Heavy Railway	Schools	Health & Hospitals	Central Accommodation	Airports	Housing	Ports	Prisons	Water & Wastewater (icl solid waste)
	Principal sectors of PPP activity					Subsidiary sectors of PPP activity					
Member States											
Austria	▲		▲	○	▲	○	○			○	○
Belgium	▲	○	○	○			▲	▲			▲
Cyprus	▲						▲▲		▲		▲
Czech Republic	▲	○	○	○	○		○	○			▲▲
Denmark	▲		▲	▲		○			▲	○	
Estonia	○			○	○						
Finland	▲	○	○	▲	○	○					○
France	▲▲▲▲	▲▲▲▲	▲	○	▲	▲	▲		▲	▲	▲▲▲▲
Germany	▲▲	▲▲	▲▲	▲▲	○	▲	○			▲	▲▲▲
Greece	▲▲					○	▲▲▲▲				
Hungary	▲▲	○		▲▲	▲			○		▲	▲▲
Ireland	▲▲▲	▲		▲▲	▲	○		▲			▲▲▲
Italy	▲▲▲	▲▲			▲▲	○	▲	○	▲	○	▲
Latvia	○							○			
Lithuania		○									
Luxembourg							○				
Malta					▲			○			
Netherlands	▲▲		▲▲	▲	○	○		○	○	○	▲▲
Poland	▲	○	○			○	○	○	▲		▲
Portugal	▲▲▲▲	▲▲	○	○	▲		○	○	○	○	▲▲
Slovakia	○						○				○
Slovenia											▲▲
Spain	▲▲▲▲	▲▲	○	○	▲	○	○		▲▲▲▲		▲▲
Sweden	○	○	○		○						
UK	▲▲▲▲	▲▲▲▲		▲▲▲▲	▲▲▲▲	▲▲▲▲	▲▲▲▲	▲▲▲▲		▲▲▲▲	▲▲▲▲
Applicant Countries / EFTA											
Bulgaria	○						○				▲▲
Romania	▲▲				▲			○			▲▲
Turkey	○	○	○				▲▲				▲▲
Norway	▲▲		○	▲	▲	○				○	

Legend

○ Discussions ongoing

▲ Projects in procurement

▲▲ Many procured projects, some projects closed

▲▲▲ Substantial number of closed projects

▲▲▲▲ Substantial number of closed projects, majority of them in operation

Source: Pricewaterhouse Coopers & EIB

Annex 2: PPP institutional and legislative developments".

	PPP Unit	PPP Law
Member States		
Austria	▲▲▲	-
Belgium	▲	■
Cyprus	-	-
Czech Republic	▲▲	■■
Denmark	▲▲	-
Estonia	▲	-
Finland	-	■
France	▲	■■
Germany	▲▲	■■
Greece	▲	■■
Hungary	▲▲	■
Ireland	▲▲▲	■■■
Italy	▲▲	■
Latvia	▲▲	■
Lithuania	-	-
Luxembourg	-	-
Malta	▲	-
Netherlands	▲▲▲	-
Poland	▲▲	■■
Portugal	▲▲	■■■
Slovakia	-	-
Slovenia	-	-
Spain	-	■■■
Sweden	-	-
United Kingdom	▲▲▲	-
Applicant Countries / EFTA		
Bulgaria	▲	■
Romania	▲	■■
Turkey	-	■■■
Norway (EFTA)	▲	-

Source: Pricewaterhouse Coopers & EIB

Key

▲	Need for PPP Unit identified and some action taken (or only a regional PPP unit existing
▲▲	PPP Unit in progress (or existing but in a purely consultative capacity)
▲▲▲	PPP Unit existing (actively involved in PPP promotion)
■	Legislation being proposed
■■	Comprehensive legislation being drafted/some sector specific legislation in place
■■■	Comprehensive legislation in place

Annex 3: PPP investment in the hospital sector

Background

The UK was the first country in Europe to make extensive use PPP structures to invest in social infrastructure such as hospitals. However, a number of other countries have now either commenced, or taken decisions in principle to establish, PPPs in the health sector. The first PPP health procurement is already underway in Italy. Spain and Portugal have recently announced significant inaugural PPP health programmes. It is expected that a number of hospital PPP projects in these countries will be brought to the EIB for consideration and decision in due course.

In part, the UK's early use of PPPs in health reflects the existence of a supportive legal framework in the sector. Much of this framework pre-dated the commencement of the current PPP programme (due to the long established practice of 'contracting out' to private companies non-clinical services such as catering and cleaning in public hospitals). Nevertheless, the UK government also considered it necessary in order to meet the specific requirements of PPP lenders to health sector schemes to introduce certain new legislative provisions before the first hospital PPP contracts were signed. A number of other European countries have, or have now adopted, legal arrangements that are supportive of health PPPs (see Annex 1).

The UK health PPP programme

The UK government is currently engaged in an unprecedented programme of investment in its healthcare estate as part of a wider modernisation of the National Health Service. In particular, over a ten year period, some 100 new hospitals and many primary care facilities are being built in England and Wales. Scotland and Northern Ireland are also benefiting from new investment programmes but these are being pursued under separate, devolved government arrangements.

PPPs have the predominant role to play in this hospital investment programme. In part, this is because the volume of investment in the UK's programme is beyond the level that can be met from the public sector resources available in the medium term. However, the principal reason for the focus on PPPs is that these have consistently been demonstrated to provide better Value For Money than conventional procurement[6]. PPPs have been shown to achieve this by:

- relating payments to the private sector specifically to service delivery;
- adopting a whole life approach to design, build and operation; and
- achieving optimal risk transfer to the private sector.

The UK's National Audit Office (NAO) has concluded that PPPs can deliver significant improvements over conventional procurements[7]. For example, based on a survey drawing heavily on experience in the hospital sector[8], the NAO concluded:

- Cost overruns for the public sector occurred in 73% of conventional procurements, but only 22% of PPPs;
- Delivery delays occurred in 70% of conventional procurements, but only 24% of PPPs.

Data from the Department of Health and reviewed by the NAO support these conclusions. Of the 19 traditionally procured hospitals delivered between 2000 and 2002, 13 were late, and four were more than two months late. In contrast, 9 of the 11 PFI hospitals completed in the period were delivered early or on time. The remaining two projects were delivered within two months of the expected date.

[6] All major hospital investment projects are required to demonstrate, as a part of their approval process, whether conventional public funding or a PPP procurement represents the best Value For Money for the public sector.
[7] PFI Construction Performance; Report by the Comptroller and Auditor General; HC 371; 5 February 2003
[8] The NAO studied the 38 PFI construction projects that were completed by summer 2002. Responses were received from 37 of these projects, 11 of which were hospital projects.

The EIB's contribution

To date, the Bank has signed three UK hospital projects and has six others in negotiation. The projects and their status are summarised in the table below.

Project name	Status	Amount EUR m
Dudley Group of Hospitals	Signed	113
Blackburn Hospitals	Signed	72
North East London Hospitals	Signed	142
Manchester Hospitals	Approved	285
Newcastle Hospitals	Approved	175
North Staffordshire Hospitals	Approved	289
The Royal London Hospital	Approved	363
St Helens & Knowsley Hospitals	Approved	260
Wakefield Hospitals	Approved	213
Total		1,912

The selection of these projects for EIB finance has been discussed and agreed with the UK Department of Health. All serve Objective 1 or 2 regional development areas. Indeed, Regional Development status is one of the main criteria against which EIB projects have been selected. The other principal criterion is the extent of health needs within the populations concerned.

The Department of Health has confirmed that the Bank's participation in these projects, and in particular its ability to provide material amounts of long maturity funding (see below) as part of an overall co-financing with other financiers, is particularly appreciated. Equally valued is the EIB's insistence that the benefits of its PPP funding should be passed through to the public sector. These factors considerably improve the affordability and Value For Money of projects for the National Health Service and the public sector more generally.

Maturities and security structures

Expected maturities on EIB loans to the UK health sector are likely to range from 31 to 35 years reflecting the financing arrangements used by UK public authorities. The maturities offered on EIB debt to these projects is justified by the economic life of the assets, the quality of the underlying UK government commitment to (and oversight of) the health sector and the credit risk profile of projects.

The credit risk associated with PPP projects such as these can be expected to decrease throughout the project term. This is primarily because once the asset is successfully constructed, the key residual risk is performance, and this risk can be expected to reduce over time. The Concessionaire is never subject to demand risk in health PPP projects.

Annex 4: Summary of National Audit Office (UK) Reports on PPPs

Value for Money Drivers in PFI, UK:

- A report commissioned by the Treasury Taskforce found that the average percentage estimated saving against the Public Sector Comparator in PFI projects was 17%.

HM Treasury research of 61 PFI projects:

Key findings were:
- 89% of projects were delivered on time or early;
- All PFI projects in the HM Treasury sample were delivered within public sector budgets;
- No PFI project was found where the unitary charge had changed following contract signature – other then were user requirements charged;
- 77% of public sector managers stated that their project was meeting their initial expectations.

The First Four DBFO Road Contracts:

The National Audit Office found that the four contracts appear likely to generate net quantifiable financial savings of around £100 million (13%).

National Audit Office survey of 98 projects by the NAO in 2001 – public authorities perceptions of Value For Money:

- 81% believed that PFI projects are achieving satisfactory or better Value For Money – only 4% described Value For Money as 'poor';
- 75% of PFI projects were delivered on time or early, and in no case did the public sector bear the cost of construction overruns, a significant improvement on previous non-PFI experience.

The PRIME Project:

The contract is estimated to deliver savings of £560 million, 22% over 20 years.

Annex 5: Extract from STAT/04/18 (11 February 2004)
New decision of Eurostat on deficit and debt: Treatment of public-private partnerships

Introduction

Eurostat, the Statistical Office of the European Communities, has taken a decision on the accounting treatment in national accounts of contracts undertaken by government units in the framework of partnerships with non-government units. The decision specifies the impact on government deficit/surplus and debt. It results from work undertaken in 2003 in cooperation with experts from European countries and different international bodies. The decision is in line with the European System of Accounts (ESA95), and is consistent with the opinion of the Committee on Monetary, Financial and Balance of Payments Statistics (CMFB).

Eurostat recommends that the assets involved in a public-private partnership should be classified as non-government assets, and therefore recorded off balance sheet for government, if both of the following conditions are met:
1. the private partner bears the construction risk, and
2. the private partner bears at least one of either availability or demand risk.

If the construction risk is borne by government, or if the private partner bears only the construction risk and no other risks, the assets are classified as government assets. This has important consequences for government finances, both for the deficit and the debt. The initial capital expenditure relating to the assets will be recorded as government fixed capital formation, with a negative impact on government deficit/surplus. As a counterpart of this government expenditure, government debt will increase in the form of an "imputed loan" from the partner, which is part of the "Maastricht debt" concept. The regular payments made by government to the partner will have an impact on government deficit/surplus only for the part relating to purchases of services and "imputed interest".

(A decision tree summarising the process proposed by Eurostat is set out on the next page.)

What is the key issue relating to Public-Private Partnerships as regards their treatment in national accounts?

The key issue is the advance classification of the assets involved in the partnership contract - either as government assets or recorded in the balance sheet of the partner. In national accounts, the assets involved in a public-private partnership can be considered as non-government assets only if there is strong evidence that the partner is bearing most of the risk attached to the specific partnership. Therefore, this analysis of risks borne by the contractual parties is the core element of the assessment of a partnership project, as regards classification of the assets involved in the contract, in order to ensure the correct accounting of the impact on the government deficit of public-private partnerships.

However, this assessment does not consider risks that are not closely related to the asset and can be fully separated from the main contract, as is the case where part of the contract might be periodically renegotiated, and subject to performance and penalty payments that do not significantly depend on the condition of the main assets.

What is the Eurostat analysis of risk in partnerships?

Many risks may be observed in practice in such arrangements. The wording used may be in addition diverse and confusing. This is why, for the purpose of this decision, Eurostat has selected three main categories of "generic" risks. Therefore, "bearing a risk" for one party means that this party bears the majority of the risk.

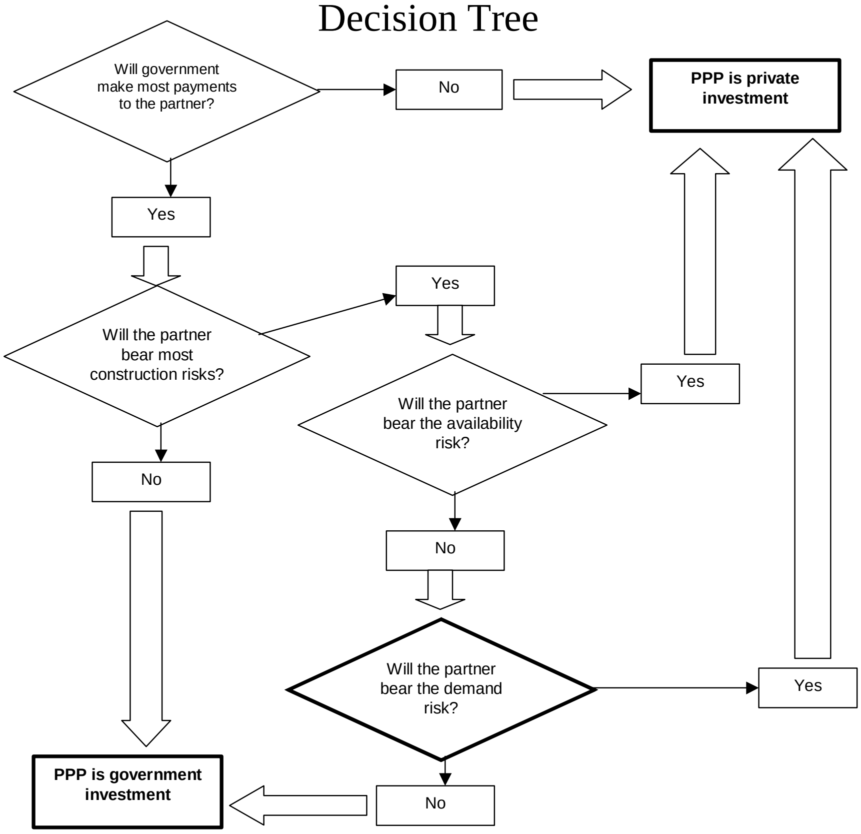
A first category is "construction risk" covering notably events like late delivery, non-respect of specified standards, additional costs, technical deficiency, and external negative effects. Government's obligation to start making regular payments to a partner without taking into account the effective state of the assets would be evidence that government bears the majority of the construction risks.
A second category is "availability risk" where the responsibility of the partner is quite obvious. It may not be in a position to deliver the volume that was contractually agreed or to meet safety or public certification standards relating to the provision of services to final users, as specified in the contract. It also applies where the partner does not meet the required quality standards relating to the delivery of the service, as stated in

the contract, and resulting from an evident lack of "performance" of the partner. Government will be assumed not to bear such risk if it is entitled to reduce significantly (as a kind of penalty) its periodic payments, like any "normal customer" could require in a commercial contract. Government payments must depend on the effective degree of availability supplied by the partner during a given period of time. Application of the penalties where the partner is defaulting on its service obligations should be automatic and should also have a significant effect on the partner's revenue/profit,
and must not be purely "cosmetic" or symbolic.

A third category is "demand risk" covering variability of demand (higher or lower than expected when the contract was signed) irrespective of the behaviour (management) of the private partner. This risk should only cover a shift of demand not resulting from inadequate or low quality of the services provided by the partner or any action that changes the quantity/quality of services provided. Instead, it should result from other factors, such as the business cycle, new market trends, direct competition or technological obsolescence. Government will be assumed to bear the risk where it is obliged to ensure a given level of payment to the partner independently of the effective level of demand expressed by the final user, rendering irrelevant the fluctuations in level of demand on the partner's profitability.

However, this statement does not apply where the shift in demand results from an obvious government action, such as decisions of units of general government (and thus not just the unit(s) directly involved in the contract) that represent a significant policy change, or the development of directly competing infrastructure built under government mandate.

Decision Tree



How will the decision be implemented in practice?

The analysis of the risks in such partnerships will be carried out in all Member States and Acceding Countries (as this decision is applicable for the next notification on 1 March 2004), under the responsibility of the National Statistical Offices.

Eurostat is of the opinion that information about such risks can easily be obtained by statisticians and that the burden of the different risks is generally identifiable in the contracts. Eurostat is also of the opinion that the assessment of risk according to the process described above would allow for a straightforward classification of the assets either "on" or "off" government balance sheet in most cases. However, it may happen in some cases that the risk analysis, as mentioned above, might not give clear conclusions (for instance if at least for two categories the share in risk may be estimated as balanced or based on very fragile hypotheses). In these cases, some additional elements in a partnership contract should also be taken into consideration. Apart from an analysis of the nature of the partners (notably in specific cases where the partner is a public corporation), the importance of government financing, the effect of government guarantees or provisions relating to the final allocation of the assets could be in some cases appropriate supplementary criteria. In this respect, if the assets remain the property of the partner at the end of the project, and if they still have a significant economic value, then it is normally classified on the partner's balance sheet. This also includes contracts where government has merely an option to buy the asset at the current market value. On the other hand, if government has a firm obligation to acquire the assets at the end of the contract at a pre-determined price that does not reflect the economic value of the assets at that time (such as expected on the basis of conservative hypothesis at the time the contract was signed), or has paid for the right to acquire the assets throughout the contract through regular payments that were higher than they would have been without that right, then there can be a reason to record the assets as government assets if the other tests do not give a clear answer.

Finally, Eurostat considers that this decision is not in contradiction with the usual business approach to such issues. In any case, specific and complex borderline cases should be closely examined according to the agreed procedure, including at a first stage the assistance of Eurostat.