3. PPPs in Europe

Jean Shaoul, Anne Stafford and Pam Stapleton,
Manchester Business School, University of Manchester (April 2007)

Introduction

While the UK is seen as the model for PPP type arrangements, the European Union (EU) has a significant role in relation to both transport in general and PPPs. The purpose of this paper is to understand the role of the EU in the context of both transport and PPPs, chart the scale of PPPs in roads in Europe and the experience of Spain, the earliest and largest user of private finance for roads in Europe.

This paper briefly outlines the development of transport policy in the EU. With the move towards the Single Market in the late 1980s, transport policy increasingly came within the EU’s remit. It encouraged the liberalisation and deregulation of transport and communications and the development of major arterial road and rail links to move both freight and people. It was in this context that PPPs began to be seen as a possible way of procuring the finance for the Trans-European Network that some member states could not otherwise afford.

The paper then reviews the development of PPP policy in the European Union, which while very supportive of the policy of using private finance, has been late to formulate an explicit policy on PPPs. Although not itself a major commissioner of PPP projects, the EU is both the overall market regulator and legislative body in terms of government procurement to ensure competition and transparency for the prospective contractors, it increasingly determines the way that PPPs are commissioned and operate. The paper outlines some of the regulatory issues posed by PPPs in relation to state aid, financing, the procurement process, first movers, subcontracting and competition, the classification of PPPs for public expenditure purposes and the responses to the EU’s Green Paper on PPPs.

The paper charts the spread of PPPs in roads, which has required extensive political and financial support. It outlines the different levels of government support, payment mechanisms and ownership structures in the member states, and the key players in the PPP market. It then reviews the experience of Spain, the first country to use private finance for roads, which was not without problems. As PPPs are relatively new, there has as yet been little research in other countries that analyses or evaluates the implementation of the policy, as opposed to describing the procurement process.
The EU and transport policy

As transport policy embraces a very wide range of issues, only those issues directly relevant to this study: the development, financing and ownership of transport infrastructure, are considered here.

The 1956 Spaak Report had drawn attention to three aspects of transport policy that would need to be covered by the founding Treaty of the European Economic Community (EEC), the precursor to the EU: non-discriminatory pricing, the development and financing of infrastructure investment, and the formulation of a common transport policy. But member states were so deeply divided that the Treaty was an awkward compromise and did not directly deal with transport policy, and such provisions as there were, Articles 70 and 71(1), the original Treaty as amended by the 1997 Treaty of Amsterdam and 2001 Treaty of Nice, were treated as though they exempted transport from the general liberal tenor of the Treaty.

It was only in the 1980s that the European Court of Justice brought transport more directly into the EEC’s sphere of competence when it ruled that anti-competitive regulations applied to transport, thereby opening up transport to liberalisation and deregulation. A second development was the 1987 Single European Act that introduced qualified majority voting to transport, one of the key areas where unanimity had proved to be an obstacle to the development of the single market. Since then, there have been deregulatory measures in all modes of transport that have paved the way for the break up and privatisation of state owned enterprises and new entrants to the transport market.

In the 1980s, the major European corporations lobbied for the expansion of large scale investment in transport as part of a broader policy of restructuring production in Europe and played a major role in placing Trans-European Networks (TENs), which covered not just transport but energy and telecoms, on the political agenda. Several new Articles, now 154-6, were added to the 1991 Treaty on the European Union that provided for the development and financing of TENs. These gave the Community power over cross border infrastructure. The Transport Network (TEN-T) that included high speed trains, waterways and airports as well as 12,000 kms of new motorways was thus written into the Maastricht Treaty.

A semi-official High Level Panel on Private Finance for TEN-T was established. At the 1994 Essen Summit, the European Council adopted 14 major transport projects, mostly rail, as priority projects crucial to the development of the internal market, although they were largely to be funded nationally. It announced €4.2bn worth of funding in the form of capital grants for the seven years 2000-2006, and endorsed the calls from the industry for public private partnerships, thereby supporting private finance for such projects.

In 1996, the cost of the TEN-T projects was estimated at €400bn by 2010. But six years later, only 20% of the total TEN-T had been completed as costs escalated. At that rate, it would take 25 years to complete the network. The nature of EU aid, capital grants, and their
small scale, were perceived as a limiting factor. In the light of the *European Initiative for Growth*, the list of 14 priority developments was increased to 30 in 2004, again largely rail schemes.

In the context of other road schemes, further EU legislation in 1995-96 enabled the selection and financing of a substantial number of smaller projects, with the EU’s poorer regions receiving substantial financial support from the EEC’s regional and cohesion funds.

While the Commission is supportive of PPPs, it concluded that they provided only a partial solution to the problem of financing transport infrastructure (EC 2003a). The Commission’s proposals to expedite the projects included road tolling, measures to modernise the EU’s procurement rules, guidance as to how to account for PPPs in national budgets and the development of a European guarantee instrument to be backed by the Commission and Member States (EC 2003b), issues which are discussed in the next section. PWC (2004b) called for the Commission to allow its funds to be used for ‘availability payments’ or recurrent expenditure as well as capital grants, arguing that this would permit the procurement of road and rail projects via a PPP structure, thereby leveraging in private finance in addition to public finance from member states.

**The EU and PPPs**

Although historically the EU has been neutral as to the ownership of assets (Article 295 of the Treaty), having no policy on privatisation *per se*, since 1999, the European Commission’s policy has been to increase the amount of private finance for infrastructure, particularly in the transport sector. It views PPPs as one mechanism for achieving several broader policy objectives: leveraging in private finance, avoiding fiscal constraints on public borrowing and improving the infrastructure. It is part of a wider push to regulate public markets so that they mimic private markets, eliminate procurement practices that favour national champions, and create an international market. It is also bound up with moves to open up and deregulate public services via the so-called Bolkestein Directive, first introduced in the European Parliament in February 2006. But while the EU has embraced the liberalisation agenda, there is as yet no EU PPP policy *per se* as there is in the UK.

The Council of Ministers endorsed the use of the PPP mechanism at their meeting in December 2003 and the EU is supportive of PPPs in certain areas. For example, the European Council called on the EC to “explore how best to mobilise private financing support of the *European Initiative for Growth* and consider how best to promote PPPs”. The *European Initiative for Growth* (EC 2003b) called for the creation of “the right regulatory, financial and administrative conditions to boost private investment” and “the refocusing of public expenditure towards growth enhancing areas without increasing public budgets”. Thus partnerships were seen as a way of boosting investment without increasing public debt, thereby fulfilling political and macro-economic objectives, the additionality argument.

There have been a number of EU statements and reviews concerning PPPs, listed in Table 1. Many of them relate to PPPs in the context of transport, particularly the TENs pro-
programme (Trans European Transport Network), in part at least because it has a budget allocation, albeit small in relation to the programme. The van Miert Report called for more use to be made of PPPs for this purpose and for the expansion and the development of PPPs and the regulation of public contracts through Community law (EC 2003c). Others have sought to facilitate PPPs in new member states and accession countries so that grants for environmental and transport projects would be available for PPPs (PWC 2004a).
Table 1  EU policy documents and initiatives relating to PPPs 1993 to date

<table>
<thead>
<tr>
<th>Date</th>
<th>Reports</th>
<th>Source</th>
</tr>
</thead>
<tbody>
<tr>
<td>1993</td>
<td>White Paper on growth, competitiveness and employment</td>
<td>Com(93) 700</td>
</tr>
<tr>
<td>1997</td>
<td>High level Group on PPP financing of TEN-T projects (known as the Kinnock report)</td>
<td>Com (97) 453</td>
</tr>
<tr>
<td>2000</td>
<td>Commission’s Interpretative Communication on Concessions under Community Law</td>
<td>OJEC (2000/C 121/02)</td>
</tr>
<tr>
<td>2003</td>
<td>Guidelines for successful public private partnerships – DG Regio and dissemination at a series of international conferences</td>
<td>DG Regional Policy</td>
</tr>
<tr>
<td>2003</td>
<td>A European Initiative for Growth – Investing in Networks and Knowledge for Growth and Jobs</td>
<td>COM (2003) 690</td>
</tr>
<tr>
<td>2004</td>
<td>Eurostat proposals on accounting treatment of PPPs</td>
<td>CMFB and Eurostat news release (STAT/04/18) February 2004</td>
</tr>
<tr>
<td>2004</td>
<td>Resource book on PPP case studies</td>
<td>DG Regio June 2004</td>
</tr>
</tbody>
</table>

Notes:
DG Regio is the Directorate-Generale Regional Policy
COM is the series reference for documents produced by the European Commission
OJEC is the Official Journal of the European Communities, now renamed the Official Journal of the European Union
CMFB is the Committee on Monetary, Financial and Balance of Payments Statistics
But EU procurement law, which is follows the framework for public procurement procedures provided by the Agreement on Government Procurement, administered by the World Trade Organisation to which most countries are signatories, does not define PPPs. Nor does EU law provide a specific set of rules governing the procurement of PPP projects. Indeed, with the wide range of arrangements that fall under the PPP umbrella, “a specific PPP directive would be difficult to formulate and even harder to apply” (Economic and Social Committee 1998: para 5.1.2). There is therefore a good deal of uncertainty about the compatibility of European public procurement rules and PPPs, which has not been clarified by the European Commission. This uncertainty relates to the contractual nature of the privately financed project from the perspective of EU procurement law and the types of procedures to be used for awarding contracts.

PFI or contractual models where the public agency pays the private partner may be either a public services or a public works contract depending upon the intention of the public authority, the contract’s specification and the ownership of the underlying asset. While the intention is usually to procure services, the lack of contract specificity which typifies PFI projects leads to negotiations with the preferred bidder prior to financial close that change the nature of the deal and raises questions about the VFM and legality of its procurement process. If the asset is to be owned by the public authority, then this is likely to form the basis of a public works contract. If on the other hand, it is to be owned by the private contractor, then the deal is likely to be a public services contract. The classification of the deal as either a public services or public works contract determines the procurement route. If it is a services contract, then there is a lower threshold for advertising the contract and the public authority may proceed under the more flexible negotiated procedure. A public works contract on the other hand has a much higher threshold for advertising, but must use the restricted procedure and is excluded from using the negotiated procedure.

Where the public authority is awarding a contract or concession, often known as a free standing project, where the user pays the concessionaire, is a grey area with inconsistent treatment for the two different types of concessions. A public works concession above a certain threshold is subject to the Public Works Directive. But public service concessions, which typically relate to more politically sensitive services, were excluded from the Public Services Directive and thus fall outside the remit of EU public procurement rules.

PWC (2004a), one of the major proponents of the policy, called for greater certainty about EU rules on procurement and funding in relation to PPPs, the funding by the EU of specially created PPP units and a central task force to assist member states, like the UK’s Partnerships UK, in creating the institutional capacity to negotiate such deals. It emphasised the importance of clarifying existing rules as they relate to PPPs over developing new ones.

Notwithstanding the definitional issues surrounding PPPs, the Commission’s desire to extend the private sector’s role in the delivery of public services means that it has had to address a range of key issues, including:
• The need to clarify public procurement rules for PPPs in the context of complex negotiations and state guarantees;
• The procurement rules for concessions, the oldest form of PPPs in Europe;
• Clarity over the issue of state aid and PPP;
• The need to develop new financing instruments, support for PPPs at EU level and institutional capacity for PPPs in the public sector;
• The need for clear rules governing the life of the contract, which can be expected to change over time and therefore opens up questions about the necessity of reopening a competitive bidding process;
• The need for a clear and consistent framework, including how they should be accounted for in both the annual accounts and national budgets.

The Commission therefore issued a consultative Green Paper (EC 2004) to examine these and other issues and to seek views of the industry on whether it was necessary to improve EU law in this area. In the event, the Green Paper dealt largely with PFI or contractual arrangements rather than concessions and joint ventures, and thus did not resolve a number of issues. Furthermore, it was pre-empted by comprehensive Directives on public procurement published one month earlier, whose aims were to open up national public procurement markets in the EU to other member states, with the result that the Green Paper has now lapsed.

Each of these key issues as they relate to this research, some of the issues raised by the Green Paper and the response to the Green Paper are discussed in turn, in order to understand the direction of the EU’s thinking on PPPs.

**Procurement rules**

As explained earlier, the type of PPP arrangements: contractual, co-ownership and those that do not fall into either category determine which the procurement rules apply. PPPs that qualify as public contracts are subject to the detailed provisions of the Procurement Directive. While most PPPs fall within this regime, some do not, including service only concessions, which must follow the negotiated procedure arrangements, joint ventures and privatisations, defence contracts, and some explicitly exempt services such as training. Within the UK, public authorities also have UK public law obligations, to act fairly, reasonably and take into account relevant considerations, and if they act outside these restrictions they are open to judicial review.

There are basically two types of procurement procedures for public service contracts, the negotiated procedure and competitive dialogue. Under Article 30, the negotiated procedure (as opposed to the restricted procedure used for clearly defined commodities as in public works contracts), is used for large contracts awarded by public authorities where the nature of the services, the risks and scale are such that it is not feasible to draw up exact specifi-
cations to allow prior pricing. It is the required route for service only concessions. It is by far the most common method of PFI procurement in the UK. The negotiated procedure is divided into stages: an initial pre-qualification stage concerned with the technical, managerial and financial resources of the bidders; the invitation to submit proposals (an intermediate stage for very large projects); the invitation to tender; and finally the selection of preferred bidder. However, as shown earlier, some negotiation frequently takes place after the selection of the preferred bidder.

Article 29 of the Procurement Directive therefore introduced the competitive dialogue procedure, a new procedure designed for PFI type contracts in order to restrict the widespread use of the negotiated procedure for major projects in some member states, particularly for large DBFO projects. It does not however explicitly restrict the use of the negotiated procedure to situations where competitive dialogue is not available. Under the competitive dialogue procedure, the public authority discusses the form of the contract and the potential specification with potential bidders, possibly in successive stages, before the key tender documents are issued. Once the tender documents have been finalised based on those discussions, the dialogue is closed and the bidders base their proposals on them. The contract is awarded to the most economically advantageous tender without any further negotiations.

The competitive dialogue is therefore less flexible than the negotiated procedure, since negotiations can only take place during the early stages of the process. But since the bidders are unwilling to incur the costs for technical, legal and financial due diligence, lenders are usually unwilling to complete due diligence in the early stages of the process. It has therefore been standard practice in PFI procurement to make adjustments after due diligence has been completed to provide comfort to the lenders, although this has on occasion meant substantial revision to the project. It would therefore seem that the procedure would not after all preclude further negotiation after selection of the bidder. That is, the issue of contractual changes during the life of a project has not been resolved.

This has generated considerable controversy, particularly in the UK where this practice is prevalent. In a number of high profile UK cases, the final project differed from that originally advertised. While contracts include mechanisms for handling minor changes, there have been concerns that there have been major modifications leading to a new or extended contract that has gone to the existing contractor under conditions where the competitive pressure had been lost. The Green Paper considers that any contract changes:

“have the effect of calling into question the principle of equality of treatment of economic operators” (EC 2004)

This would require that any substantial modification should be considered as a new contract and therefore subject to a new round of competition. It is indeed true that such changes are usually seen as an opportunity for the private sector to take advantage of their
“monopsonistic” position at the expense of the public sector, since the public sector is essentially “locked into” one supplier (Lonsdale 2005). However, the Green paper’s requirement is unlikely to be a practicable solution for either party, as the renegotiation of the UK’s NIRS2 (Edwards and Shaoul 2003) reveals, making the policy inoperable. Rather, it is likely to deter the private sector from agreeing contracts if every substantive change had to be re-tendered.

The Green Paper points out that secondary legislation lays down the exceptional circumstances that would permit additional works or services without competition, but insists that such exceptions be interpreted restrictively. It specifically cites the example of extending a motorway concession to cover the cost of completing a new section (as has occurred in Spain) and warned against the practice of combining profitable and non-profitable activities so that a new activity is awarded to an existing concessionaire without competition.

**PPPs and State Aid**

The EU generally prohibits State Aid to private enterprises except under tightly defined conditions such as support for underdeveloped regions, the promotion of a project of common European interest, restructuring, and to pay for externalities. If public subvention does not satisfy these conditions, then it constitutes State Aid and any subsidies must be refunded and the enforceability of any guarantees is uncertain. As yet the issue of State Aid and PPPs has not been a major issue. But if financing structures are developed that include State Aid and/or European grant financing, then there would be a need to ensure compatibility between PPPs and State Aid rules. Where there is a competitive tender process, the scope for legal challenges under the State Aid rules is limited. However where the negotiated procedure is used, should there be alterations to the contract after the selection of the preferred bidder, there is a risk of a legal challenge.

In 2002, the Commission made one of the few rulings on the issue, in the context of the London Underground PPPs. Here the government, which had originally expected to terminate all grants to London Underground, had announced a grant to cover the cost of investment under the PPP and that the private sector debt would be guaranteed, after selection of the preferred bidders. The Commission ruled that that this grant did not constitute State Aid and thus the PPP contracts did not breach EU rules. It confirmed the principle that the state should pay for any externalities. Its decision appears to imply that complex infrastructure projects can be awarded after extended tender procedures involving alterations to the contracts and government grants and after the appointment of the preferred bidder, without automatically constituting State Aid and thus potentially an unfair advantage. The Commission found that public procurement rules had been followed; and that the maximum potential transfer of value to the bidder was reasonable for contracts of this type. In addition, it found that that the combination of the continuous review process, the arrangements for subcontracting by competitive tender, the commercial incentives built into the contract, and
London Underground’s audit rights served to limit the payment mechanism departing from the market price in future years.

But it is possible that this issue could be become more important in future PPPs. Should the State Aid rules be breached, the consequences could be serious for the private sector. If the payment mechanism is deemed to be too generous, then the government could be ordered to reclaim the excess. Perhaps even more importantly, any state guarantees, on which financiers may be relying, may be unenforceable.

**PPPs and financing instruments**

In order to develop the use of private finance in major infrastructure projects, it is argued that there is a need for the EU to develop additional financing mechanisms. The European Investment Bank (EIB), funded by member states and accountable to the European Parliament, has played a major role in promoting PPPs by providing finance for PPPs and particularly transport projects, and developing new financial instruments and initiatives. Furthermore, it is represented on various bodies concerned with PPP issues. The EIB, which lends at lower rates than commercial banks, serves to reduce the cost of borrowing, a benefit that has not always been passed on to the public authority (EIB 2005), and its imprimatur facilitates additional loans elsewhere in the financial market. In effect, this permits public sector credit with private sector returns.

The **European Initiative for Growth** (2003b) lists several instruments which the Commission believes are relevant here:

- The provision of third party equity or quasi equity alongside grant aids and contributions from the public authorities. For example, under the TENs Financial Regulation, some of the budget may be used for equity or quasi equity investments in projects;
- Securitisation;
- The EIB’s Structured Finance Facility which contributes to the provision of debt finance for the early, pre-construction stages of projects;
- The European Guarantee Instrument to cover specific risks in TENS projects in their post construction phase.

But it is far from clear that the lack of finance for PPPs is a problem. Shortage of finance has not generally been a problem as purchasers, such as pension funds, view PPP projects as quasi government debt that meets their needs for long term investment. In addition, a number of European banks are buying low rated PPP debt to balance their high risk debt. Where the projects are structured in ways that make it attractive to the private sector and are affordable to the public sector, then finance has usually been forthcoming. In other words, the broader political support for the project, including public contributions, are crucial for determining its financing, not the lack of institutions willing to lend.
More importantly, the financial sector has sought to mitigate its risk by securing explicit or implicit guarantees from government and/or purchasing government-backed securities. In this context, it is worth noting that the UK government has introduced a Credit Guarantee Facility (CGF) (Treasury 2003), whereby the roles of financing and risk taking are separated in an attempt to cut the cost of finance by 5-10%. Under CGF, the government issues bonds at lower cost on the gilt market and passes them onto the project company at market rate. In order to mitigate risk, the government takes a guarantee of repayment from a commercial institution such as a bank or monocline provider. As yet, however, few UK PPPs have been financed in this way.

First movers

The issue of first movers or unsolicited proposals has been another contentious issue. The Green Paper supports proposals that “first movers” should have some privileged treatment to maintain the incentive to initiate proposals for public spending on their projects. But such proposals enable extra contracts or less competitive contracts and create the potential for both corruption and higher costs for the public agency since they preclude the evaluation of alternatives. Many of the world’s most controversial private infrastructure projects originated as unsolicited proposals to governments leading to “many negative experiences” as the World Bank has noted (Hodges 2003).

Subcontracting and compulsory competitive tendering

Since, under current rules, the main contractor is not required to submit all its contracts to competitive tendering, many project companies subcontract to their sister companies, the usual practice in UK PFIs. The Green Paper recommends that the prime contractor should be required to submit all its contracts to compulsory competitive tendering. Although this is not required in the UK, it is worth noting that London Underground did demand that Metronet, one of the London Underground PPP companies before its demise, put out all its subcontracting to tender in attempt to rein in its projected £2bn overspend. In the event, however, Metronet collapsed before this was implemented.

The Green Paper also calls for compulsory competitive tendering when the public sector contracts with an arms length public company or corporatised public body. This would therefore widen the scope of PPPs to include arrangements that include operators that are public enterprises not belonging to the general government sector, so called ‘project vehicles’ and in effect provide a mechanism for increasing external outsourcing.

The classification of PPPs for public expenditure purposes

A key motive for PPPs has been the desire on the part of governments to evade the EU’s fiscal constraints that limit the amount of public debt. The private sector also supported this as it believed that it would encourage the turn to private finance. In this context, PWC (2004a) therefore argued for the structuring of deals and the development of national ac-
counting rules that would permit transactions to be scored as off balance sheet, thereby evading the constraints on public debt imposed by the Stability and Growth Pact.

But it was unclear, until the ruling by Eurostat in February 2004, whether assets underpinning the services provided under PPP were classified as non-government assets and thus both the assets and their corresponding debt obligations recorded off the government's balance sheet. Under Eurostat's ruling, unless the private partner bears the construction risk and either the availability or demand risk, then the asset will count as a public sector asset. While this was widely viewed as a measure to rein in off balance sheet projects, in practice these are easy requirements to fulfil. It would seem therefore that the Commission has moved from neutrality in relation to ownership to a preference for private ownership.

Response to the Green Paper

While there were about 200 responses to the Green Paper, largely from governments, both regional and national, there was no consensus that PPPs needed further regulation. Many thought that it would be better to wait to see how the new procurement Directives would work. There was generally little concern about the lack of homogeneity. In fact, the corporations saw this as a definite advantage, as the complexity favoured the sophisticated operator with experience and regulatory and market knowledge. Most responses did however seek clarification of the position relating to concessions and choice of private sector partners by "institutionalised PPPs" where there is a joint public/private-owned public service entity. The EC's response to the consultation was to commission a study into the current practice for procuring PPP services within the EU and the impact of a new EU legislative initiative to regulate the procurement of concessions. But as of November 2007, this had not been published.

Road PPPs in the EU

In 2005, the annual capital value of signed deals in the EU, excluding the UK, had reached €9.3bn, before falling back to €7.7bn in 2006. Italy, Spain and France had signed the largest number of private finance deals. By far the largest PPP sector is transport, particularly roads and motorways. Rail, tunnels and bridges also feature among the largest projects. It is however extraordinarily difficult to get information about signed PPP deals as there is no one database of signed PPP contracts in roads or indeed any other sector in the European Union, and such information as is available is incomplete. Data collected for this study shows that by the end of 2005, the 25 countries that make up the EU had signed at least 145 PPP type arrangements for the construction and maintenance of roads, bridges and tunnels, by far the largest sector by value financed by the EIB (EIB 2005). As Table 2 shows, these projects are funded by different combinations of tolls, private finance and taxpayers' money via shadow tolls, which are usually volume-based payments by the public sector on behalf of users.
Table 2 The number of PPP road projects in the European Union

<table>
<thead>
<tr>
<th></th>
<th>Roads (toll)</th>
<th>Roads (shadow toll or availability)</th>
<th>Roads (unknown payment mechanism)</th>
<th>Bridges</th>
<th>Tunnels</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Spain</td>
<td>35</td>
<td>17</td>
<td>2</td>
<td>5</td>
<td></td>
<td>59</td>
</tr>
<tr>
<td>UK</td>
<td>1</td>
<td>22</td>
<td></td>
<td>3</td>
<td></td>
<td>26</td>
</tr>
<tr>
<td>Portugal</td>
<td>4</td>
<td>7</td>
<td></td>
<td></td>
<td>1</td>
<td>12</td>
</tr>
<tr>
<td>Greece</td>
<td>6</td>
<td></td>
<td>1</td>
<td>1</td>
<td>1</td>
<td>9</td>
</tr>
<tr>
<td>Italy</td>
<td>4</td>
<td></td>
<td>5</td>
<td></td>
<td></td>
<td>9</td>
</tr>
<tr>
<td>France</td>
<td>5</td>
<td></td>
<td>1</td>
<td>1</td>
<td></td>
<td>7</td>
</tr>
<tr>
<td>Ireland</td>
<td>3</td>
<td></td>
<td></td>
<td>3</td>
<td></td>
<td>6</td>
</tr>
<tr>
<td>Hungary</td>
<td>2</td>
<td>3</td>
<td></td>
<td></td>
<td></td>
<td>5</td>
</tr>
<tr>
<td>Netherlands</td>
<td>2</td>
<td>3</td>
<td></td>
<td></td>
<td></td>
<td>5</td>
</tr>
<tr>
<td>Germany</td>
<td></td>
<td></td>
<td></td>
<td>2</td>
<td></td>
<td>2</td>
</tr>
<tr>
<td>Poland</td>
<td>2</td>
<td>1</td>
<td></td>
<td></td>
<td></td>
<td>3</td>
</tr>
<tr>
<td>Finland</td>
<td></td>
<td>2</td>
<td></td>
<td></td>
<td></td>
<td>2</td>
</tr>
<tr>
<td>Total</td>
<td>62</td>
<td>54</td>
<td>11</td>
<td>8</td>
<td>10</td>
<td>145</td>
</tr>
</tbody>
</table>

Sources: various
Note: Signed deals as at Jan 1 2006

The very first road projects were signed by Spain, which signed 15 projects, all for toll roads, between 1967 and 1975. There was then no activity until 1987 when both the UK and Ireland signed bridge projects, and Spain signed a tunnel project and another toll road. By the end of 1995, 28 projects had been signed including two road projects from Hungary, the first of the accession countries to utilise PPPs in roads, though both projects subsequently failed. In 1996, the UK’s Highways Agency signed the first eight DBFO shadow toll projects and Greece began signing projects as part of its PPP toll road program. In 1997, Finland signed the A4 road and Poland signed their first two projects. In 1998, Spain began a new programme of road building with PPP type arrangements, using shadow payments for the first time on two of them. In 1999, a further 14 projects were signed including the Herrentunnel in Germany and the first of Portugal’s SCUT programme. By the end of 1999,
there were at least 65 signed projects. After that, the number of signed deals grew quite fast and by the end of 2005, 145 projects had been signed.

The extent and pace reflects both national political priorities and national legal frameworks. By far the largest user of private finance in roads by capital value is Spain, with about €14.5bn of projects by 2006. It is also the longest user: its experience of private finance going back to 1967. The UK comes second with about £3.3bn of PPPs. Other major users of private finance include Portugal, Greece, France, Italy, Ireland and the Netherlands. Some have an active PPP road building/upgrading programme. While France and Italy used PPPs in the roads sector on an ad hoc basis, they are now beginning a more active PPP programme. Countries such as Germany, Hungary, Poland and Austria have used PPPs for individual projects rather than as part of a wider programme of PPPs. While Germany has now started a PPP roads programme at the state level, deals have yet to reach financial close. 12 countries have no signed roads projects. While some of these have signed PPPs in other sectors, most had not signed any deals and were not expected to do so. But taken together, given the long gestation period before such projects become operational, there are relatively few projects that are up and running.

Government support has played a key role in the expansion of PPPs as the experience of both the UK and Spain, discussed in the next section, shows. Indeed, PWC (2004b) has remarked that the extent of private sector involvement is chiefly associated with the political will of member states to promote them. This may take several forms. Firstly, the establishment of one or more PPP development units at central government level and/or in key departments, along the lines of the UK’s Treasury Task Force and PFI units, in Austria, Ireland, the Netherlands, Denmark, Germany, Italy and Portugal, and secondly, the development of generic PPP legislation, as in Ireland, France, Germany, Portugal and Spain. Nevertheless, the complexity of such deals means that the procurement process is lengthy.

The payment mechanisms vary between countries. While several countries have toll roads, until very recently only Spain had privately owned and managed toll roads. In the 1990s, the UK used shadow tolls as its way of paying for its roads projects. In more recent projects, following criticism from the UK’s National Audit Office of shadow tolls which transfers risk to the private sector which it is unable to control (NAO 1998, 1999), the UK has developed new payment mechanisms, such as availability payments linked to traffic speed and/or deductions for lane closures. Some payment systems aim to maximise safety. The UK and elsewhere, including Spain now use some mix of availability/shadow tolls for public DBFO schemes.

The PPP ownership structures vary between countries. In France, concessions tend to be held by single and national construction firms with relatively little bank involvement, whereas elsewhere concessions/contract are held by consortia that involve banks and construction companies, typically larger foreign companies and some smaller national firms. In other countries, the consortia, made up of international companies, subcontract to smaller local firms. The consortia are made up of shifting alliances of companies so that while the same companies win many of the deals, it is not generally the case that the same consortia
or SPVs win many bids. In so far as consortia have several projects, this is usually the result of takeovers.

Large scale projects require and attract a limited number of highly experienced bidders so there is limited effective \textit{ex ante} competition even in the best organized tendering processes (Estache and Serebrisky 2004). It would indeed be highly unlikely to get more than three or four bidders for large projects as industry concentration means that there are few players. Some markets such as France, Spain and Italy are seen as ‘closed’ because of strong domestic contractors and as such conflict with the EU’s desire for international markets. The UK, Germany, Belgium, the Netherlands and Portugal are perceived as more open.

Some six infrastructure companies have been involved in 50% of the 147 projects for which data relating to the partners were available and 16 in 90% of the projects, although more than one infrastructure company was involved in some projects. The Spanish companies (Dragados, Ferrovial, Abertis, OHL, FCC, Acciona and Sacyr) accounted for 52% of all new concessions and PPP projects over US$50m under construction and signed between 1985 and 2003, although some of these companies have since merged. British Companies (John Laing, AMEC, Balfour Beatty and Alfred McAlpine) accounted for 14%. French companies (Vinci-Cofiroute, EGIS, Bouygues, Alstom) accounted for 14% and Australian companies (Macquarie, Transfield) accounted for 9%. The French and Spanish contractor groups have done well outside their own domestic markets, as well as ensuring that they retain their position at home. The most usual methods to enter overseas markets include lending to an existing operation, finding a domestic partner, and merging with or acquiring a domestic organisation.

Concentration in the construction industry has increased in recent years following takeovers and mergers and this has led to reduced competition in PPP procurement (Stambrook 2005). This creates increased risk for the public sector because the companies are large and powerful enough to take on the regulators in the case of conflict and force contract renegotiation on more favourable terms (Molnar 2003).

While the information about the projects’ financial backers and technical advisors is only available for about 90 of the 147 projects, it is clear that road PPPs frequently involve international financiers. The EIB has wholly or in part financed at least 50 such projects. The UK and Spanish banks have been involved in a number of the projects: Royal Bank of Scotland (16 projects), Banco Bilbao (15 projects) Banco Santander (9) and Lloyds TSB (9), in part also reflecting the predominant weight of these two countries in such schemes. The German banks are however more heavily involved than the number of German projects would suggest.

While the predominant mode of operation in the UK is non-recourse financing via a project vehicle, whether bond or debt, it is still common in the EU to see a form of short term corporate debt of six or seven years for the construction phase. Within the European banks, there are a limited number of banks with project finance experience. While the structured or
project finance teams are mainly based in London, the banks to whom those teams belong to are German, French, Dutch and British. In addition there are American and European investment banks with bond and debt teams and American monocline insurers that wrap the project risk for bond and debt holders. Thus, the banks with experience of project finance have been able to enter countries such as Italy and Spain, which traditionally have used corporate debt. In Germany, where the public authority effectively guarantees the repayment of the bank debt and hence underpins the Landesbanks that lend on such projects, two developments are likely to mean that Germany too will move away from corporate debt to project financing. Firstly, the European Court of Justice has criticised such arrangements under State Aid regulations and secondly, there are tighter provisioning requirements under Basle II for such arrangements with local banks. Thus, just as the corporations involved are international, so increasingly are the financing arrangements. Furthermore, as the projects become ever larger, the advantages of project finance, that serves to isolate risks, will become more apparent.

The major advisors are dominated by the international Anglo-Saxon partnerships and include financial consultants PWC (23 projects), the engineering consultants Halcrow (13), Bank of America (10 projects), legal advisors Denton Hall (10 projects) and Faber Maunsell, Hambros and Steer Gleave Davis (each with seven projects). The UK advisors, or the British affiliates of international firms, have generally led the field as the UK model is generally perceived as a good starting point in risk allocation.

Private finance for roads in Spain

Spain has been by far the largest user of private finance for infrastructure, with the private sector financing 20% of its infrastructure investment. Its private toll road programme began in 1967 with the offer of contracts of up to 50 years to the private sector to build, finance, and operate roads, and the right to charge vehicles to use the roads, alongside free roads, as isolated concessions rather than a network. The 1972 Concession Law, superceded in 2003 by a new law that covers all types of PPP, including the PFI model, was primarily intended for roads. The turn to private finance would, it was argued, provide the finance for infrastructure that the state itself could not afford. In general, those roads that were most likely to be profitable were franchised.

The private roads were not, however, built without cost to the Spanish government or financial problems for the companies involved. According to Bel and Fageda (2005), the financial, fiscal, and commercial conditions of the franchises were such that almost every risk was borne by the government. In particular, it provided state backed guarantees for foreign loans and exchange rate insurance against any increase in the cost of finance raised by international loans, thereby reducing the concessionaires’ exchange rate risk.

But several of the toll roads encountered financial problems because of high construction costs, the additional costs associated with tolling, and low revenues due to lower traffic volumes than anticipated, since many road users preferred to use the free roads. Spain’s economic and exchange rate crisis of the 1970s and early 1980s following the rise in oil
prices in 1978-79 further undermined the financial viability of the concessions. Three had to be taken into public ownership in 1984, a large number of the foreign loans had to be renegotiated, state loans were made available, the remaining contracts had to be renegotiated and in some cases, public subsidies were given (Farrell 1997). By the end of 1994, the government had paid out 2.65bn ECU and had further liabilities of 1.5bn ECU in relation to foreign exchange guarantees that had not yet been called (Farrell 1997). So expensive was the experience that in 1982, the incoming Socialist Party government reverted to a programme of road building based upon conventional public procurement, contingent upon economic expansion, increased tax revenues and, after 1985, extensive funding from the European Commission.

In the 1990s, after the constraints on public debt imposed by the European Union, the incoming Conservative government once again turned to concessions for new roads. But by this time, the concessionaires, having formed in 1973 a trade association to promote their interests, had gained various legal, financial and accounting benefits from successive governments, which traditionally have had a close relationship with the construction industry. This was crucial in establishing a more secure financial regime for the private sector.

Firstly, the government passed a law to enable concessions of up to 75 years. Secondly, it renegotiated 13 year extensions to the existing agreements without entering into competitive bidding, legal under EU procurement law at the time and in some cases renegotiated the extensions in return for lowering toll prices, hence increasing traffic flows and thus revenues, or undertaking further investments in other motorways where financial returns might be low. According to Bel and Fageda (2005), the renegotiations resulted in huge profits for the companies.

Thirdly, the government acknowledged that huge subsidies would be necessary for many of the new toll franchises to enable them to sustain the low levels of projected traffic volumes and the consequent financial losses (Bel and Fageda 2005). According to Izquierdo (1997), half of the projected highways in the first phase of the new programme would require subsidies ranging from 40-65% of the total investment, which he expected to be in the form of ‘non-refundable subsidies’ or ‘refundable advance payments’, the then traditional forms of public support. In the event, the government changed its policy of supporting the concessionaires via direct subsidies and introduced what became known as ‘participative loans’, whereby the companies had access to cheap loans from the public authorities for some part of their financing requirements, and whose repayments were linked to their revenues from toll charges. Such arrangements, being scored as off the public sector’s balance sheet for fiscal purposes, served to circumvent the constraints on public debt.

Fourthly, the concessions have benefited from a favourable pricing regime. The contracts awarded before 1988 were subject to little price regulation. In 1990, legislation established annual indexation of the tariffs slightly below inflation: increasing by 95% of the Consumer Price Increase (CPI) of the previous 12 months, subject to the permission of the corresponding public authority. During the late 1990s, there were individual agreements with
each concessionaire to reduce tariffs and apply selective discounts, mainly to regular users.

In both 1997 and 2000, the government refused to allow charges to rise in line with rising and relatively high inflation. However, this did not lead to a corresponding reduction in post tax profits due to increasing motorway usage. The government’s objectives in freezing the toll charges were to control inflation, improve the distribution of traffic by encouraging the use of toll motorways, because many of them were underused while the alternative free roads were heavily congested, and to share the rising profits between the concessionaires and road users. In other words, by freezing the toll charges, it sought to increase traffic flows and thereby their revenues. However, the freeze was later ruled illegal and the government had to compensate the concessionaires.

Since 2000, a new system of revising tariffs, based upon price cap regulation, has been applied to the central government’s toll concessions. This method is also based on the CPI but adjusted according to actual as opposed to forecast traffic. In essence, the largest toll increases are granted to the roads with the lowest traffic increases, and the lowest to those with the largest increases. The net result of this form of regulation, including the reduction in prices, has been to increase the volume of traffic using the toll roads (Bel and Fageda 2005), and thereby their profits. The system is not however universal, as the autonomous regions continue to revise tariffs based on annual increases of 95% of the CPI.

Fifthly, as Yescombe (2007) notes, the procurement process is fast and low cost, with Spanish projects incurring bidding costs about one tenth those for a British PFI and procured within a much shorter time. This is apparently due to the greater amount of preparation by the public sector, including preliminary design, planning and environmental impact assessment, and prior consultation with the market before launching PPP tenders. In other words, greater costs are absorbed by the public sector directly and the private sector makes a much greater input into the nature of the projects it is willing to bid for.

Lastly and most importantly, the companies were able to secure a beneficial accounting regime that had real economic effects (Acerete et al 2009). The two most important benefits were the establishment of a reversionary fund, analogous to an additional depreciation fund, and the treatment of financing expenses such as interest payable.

Firstly, under Spanish accounting regulation, companies that operate an infrastructure concession, such as water or transport, whose assets will revert to the state at the end of the contract, could establish a reversionary fund. This became mandatory in 1999 for road concessionaires. Such a fund is created by making an allocation to a long term provision every year over the life of the concession, thereby increasing cost. Since the government accepts that the tariff must be set to cover not only the operating and financing costs but also the reversionary charge, this means that the road users must pay sufficient to cover this higher cost. In other words, the users will have fully paid for the asset over the life of the concession, which is shorter than the life of the asset. This allocation serves to increase the cash available to the company and is allowable for tax purposes.
Secondly, in relation to the treatment of financing expenses, in contrast to the international position, these can continue to be capitalised even after the asset becomes operational, subject to the existence of reasonable evidence that they can be recovered from future tariffs. While this is explained simply as a timing difference that should even out, in practice it serves to increase the returns to shareholders at the beginning of the contract, with no evidence to suggest that this will be reversed in the later years. Together, the reversionary fund and the treatment of capitalised interest have played an important part in consolidating the financial position of the concessionaire companies, enabling them to become a powerful force and global players in the road construction and operating business.

The use of private finance and tolls went alongside a further expansion of publicly procured and free motorways. By the end of 2004, 2,900km of private toll highways and 9,020km of free highways were in operation. Between 1995 and 2005, 19 private finance deals were signed, some being new developments for existing contracts. While eight were operational by 2002, some had still to open.

The Spanish PPP projects are dominated by the major construction companies and their subsidiaries. The financial investors play a much smaller role in financing the projects, as opposed to financing the companies. In effect, Spain operates as a market closed to foreign competition, although there is keen competition between domestic contractors. The road concessions have played an important role in boosting the construction companies’ financial position and providing them with a launching pad to bid for similar deals overseas, particularly in Latin America.

In short, the Spanish experience is consistent with experience elsewhere in that concessions had to be renegotiated or taken over by the government when the concessionaires faced inadequate revenues due to users’ dislike of tolls, and/or higher than expected costs (Silva, 2000; Estache and Serebrisky, 2004; Acerete et al., 2009). The early contracts suffered from an overestimation of traffic volumes, the public’s dislike of tolls, and the higher than anticipated costs, leading to the renegotiation and the public takeover of some concessions, and higher, but unquantified, costs for the government that appear to negate the stated objectives of the turn to private finance. The government’s steps to make the more recent concessions more financially viable for the private sector were key to ensuring the financial viability of the projects and ensuring healthy returns to both the financiers and owners in the last 10 years (Acerete et al. 2009).

**Conclusion**

The EU’s enthusiasm for PPPs is linked to its wider deregulatory and pro-market agenda and the development of Trans-European Networks in transport. The Maastricht criteria have thus far provided the main rationale for PPPs in the context of a tight fiscal environment facing national governments. As such PPPs were promoted as a way of implementing the EU’s transport policy. The EU does not however itself either commission or directly fund major transport schemes, although the EIB has been involved in financing a large number.
The lack of an explicit EU policy on PPPs and the diversity of practice in member states is viewed favourably by some large and powerful corporations, since the complexity favours the sophisticated operator with experience and regulatory and market knowledge. The use of private finance for public infrastructure is increasing and takes several forms, not all of which are identical to those in the UK, which makes regulation difficult.

The EU supports the use of private finance and Partnerships, and plays a major role in framing policy via its rules on procurement and competition that impact on PPP procurement. However, the position relating to concessions and choice of private sector partners by “institutionalised PPPs” where there is a joint public/private-owned public service entity is seen as requiring clarification and a more uniform practice.

While the EU’s competition and procurement rules impact on the development and use of PPPs in member states, the expansion of PPPs is dependent upon the degree of political, institutional and regulatory support within each country. This, as the experience in Spain has shown, makes it imperative that there is full and timely disclosure of all the public subventions that may continue long into the future and/or may be called upon if things go wrong. The deregulation of transport and the growth of concessions and PPPs have been instrumental in creating large and powerful infrastructure companies, particularly in Spain, and financiers specialising in PPPs.

One implication of the creation of public markets in public infrastructure and services via PPPs and taking such arrangements outside the scope of public finance is that it is paradoxically the beginning of the end to public sector decision making and control of procurement. This matters since the private sector’s objectives lie with profit maximisation whereas the public sector’s, at least in principle, lie with the public interest. The inexorable logic of the move to markets is that the private sector initiates its own proposals for service delivery and submits its plans to the public authorities, as what are known as unsolicited proposals, which would entail the dismantling of public markets in favour of private markets. This in turn leads to an agency-like relationship between the private and public sectors in that the former provides the services and the underlying infrastructure on behalf of the latter, thereby attenuating governance.

Such a system needs extensive transparency and accountability, particularly on the part of the private partners if the public’s needs and interests are not to be subordinated to those of the private sector and the VFM that lies at the heart of the Partnerships policy is to be achieved in practice. At very least, the regulation of the reporting of such transactions needs to recognise these requirements.

References


Economic and Social Committee (1998) Opinion of the Economic and Social Committee on the ‘Communication from the Commission to the Council, the European Parliament, the Economic and Social Committee and the Committee of the Regions on Public-Private Partnerships in Trans-European Transport Network projects’ Official Journal of the European Communities, C 129/58


Izquierdo, R. (1997) “Gestion y financiacion de las infraestructuras de transporte terrestre” Madrid Asociación Española de la Carretera

Molnar, E (2003), Trends In Transport Investment Funding: Past Present And Future, UNESCO and CEMT/CS/12


Stambrook D (2005) Successful examples of public private partnerships and private sector involvement in transport infrastructure development, final report under contract with OECD/ECMT Transport Research Centre, Contract # CEM JA00028491, Virtuosity Consulting, Ottawa, Canada

Treasury (2003), PFI: Meeting the Investment challenge, HM Treasury, London


Butterworth-Heinemann, Oxford

Acknowledgements

The authors gratefully acknowledge research funds from the Institute of Chartered Accountants of Scotland, research support by the University of Manchester’s Research Centre for Socio-Cultural Change (CRESC), which bought out Jean Shaoul’s time in 2007 for her to work on this project, and research assistance from Peter Macdonald.

This paper was published originally as a chapter in “Financial black holes: accounting for privately financed roads in the UK”, Institute of Chartered Accountants of Scotland, Edinburgh, 2008.

Address for correspondence:

Professor Jean Shaoul
Division of Innovation, Management and Policy
Manchester Business School
University of Manchester
Manchester M15 6PB
Jean.shaoul@mbs.ac.uk
Tel no 0161 275 4027