

# Evaluation Report

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*Operations Evaluation (EV)*

## **Evaluation of PPP projects financed by the EIB**

Synthesis Report



# **EVALUATION REPORT**

## **Evaluation of PPP projects Financed by the EIB**

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### **NOTICE**

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# Evaluation

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## GLOSSARY OF TERMS AND ABBREVIATIONS

BAFO	Best And Final Offer, a second stage bid in a public procurement competition.
Board (of Directors)	The EIB Board of Directors which has sole power to take decisions in respect of loans, guarantees and borrowings.
CD	EIB's Management Committee ( <i>q.v.</i> )
CA	EIB's Board ( <i>q.v.</i> )
Centre of Expertise	Horizontal unit within OPS to disseminate skills and expertise in key areas of activity, e.g. PPPs.
Chinese Walls	A set of procedures and protocols established within an organisation to avoid conflicts of interest when dealing with competing clients.
Concession	A contract between the Promoter and the Provider (Concessionaire) to provide a specified service or facility ( <i>e.g.</i> a road) over a specified period, with payments being made by end-users.
EIB	European Investment Bank
EIRR	Economic Internal Rate of Return
Eurostat	European Union institution responsible for the collection and analysis of EU-wide statistical information.
EV	EIB Operations Evaluation (Ex-Post)
FI	EIB Finance Directorate
Financial Close	The point at which commercial and financing contracts have been signed and conditions precedent to the first debt drawdown have been fulfilled
FIRR	Financial Internal Rate of Return
IDC	Interest During Construction
JU	EIB Legal Directorate
Management Committee	Internal EIB committee, comprising the Bank's President and Vice-Presidents
O&M	Operation and Maintenance
OPS	EIB Directorate for Lending Operations (OPERATIONs)
Ops-A	EIB Directorate for Lending Operations – EU Member Countries
Ops-B	EIB Directorate for Lending Operations - Other Countries
PFI	Private Finance Initiative, a term primarily used in the UK for PPP projects
PJ	EIB ProJects Directorate – Responsible for the ex-ante techno-economic analysis of the projects and physical monitoring of implementation and completion.
PIN	See RQ
PPP	Public-Private Partnership – see §2.1
Project	A clearly-defined investment in physical assets, e.g. a specific section of road, a bridge, etc.

Project Finance	A loan made primarily against the cash flows generated by the project, rather than relying on a corporate balance sheet, the security value of the physical assets, or other forms of security.
Promoter	Normally the <i>persona</i> responsible for identifying, developing, implementing and operating a project. Specifically on PPPs, the Promoter is the public-sector awarding authority responsible for identifying and developing the project, managing the PPP process, and the signatory to the PPP contract.
Provider	The <i>persona</i> responsible for the implementation and operation of a PPP project, under the PPP contract with the Promoter.
PSC	Public Sector Comparator: A procedure by which a Promoter seeks to compare the total cost of creating, operating and maintaining a piece of public infrastructure using the PPP mechanism as opposed to using direct public-sector procurement.
Real Toll	Payment mechanism whereby the Provider's revenues come directly from the users of the infrastructure, e.g. roads, bridges.
RM	EIB Risk Management Directorate, responsible for credit appraisal and portfolio management
RQ/PIN	Relevé Quotidien/Preliminary Information Note – Note which formally launches the project cycle within the Bank, outlining the main characteristics of the proposed operation.
Shadow Toll	Payment mechanism whereby the Provider's revenues come from the Promoter, based on usage of the project, rather than the end-user directly.
SPV	Special Purpose Vehicle – A company, with its own legal <i>persona</i> , set up for limited set of specific purposes, e.g. to borrow for the construction of a project, to place contracts for construction and maintenance, and to receive remuneration.
Swap (Interest Rate Swap)	A hedging contract to convert a variable interest rate into a fixed rate.
TA	Technical Adviser – Engineering consultants retained by the lenders to monitor technical and engineering aspects of the project.
TENs	Trans-European Networks. Priority transport and communication links for the European union
Turnkey (contract)	A contract for the design and construction of a complete project.
UKIDE	EIB Lending department responsible for UK, Ireland and Denmark
VfM	Value for Money. A measure of the economic efficiency of a project.

## EXECUTIVE SUMMARY AND RECOMMENDATIONS

### Introduction

This report presents the findings of an evaluation of “Public-Private Partnership” (PPP) Projects financed by the EIB. Fifteen projects which were either fully operational or close to full completion were selected for a desk review, based on data and information available within the Bank. Ten of these were then selected for in-depth evaluation, covering the scope and geographical range of the Bank’s PPP portfolio. The evaluation assessed the performance of the projects against the Bank’s standard evaluation criteria<sup>1</sup> in line with normal EV practice, but also paid particular attention to the Bank’s role in the process and the impact of the PPP structure on both the project and the Bank.

Concession-based transport and utilities projects have existed in EU Member Countries for many years, particularly in France, Italy and Spain, with revenues derived from payments by end-users, e.g. tolls. Expansion to a broader range of public infrastructure, combined with the introduction of payment by the public sector rather than end-users, started around 1992 with the introduction of the “Private Finance Initiative” (PFI) in the United Kingdom. While the use of PPPs has spread to most EU Member States, the UK is still the largest and most diverse PPP market.

There is no simple, single, agreed definition of the term PPP. So, for the purposes of this evaluation, a PPP was defined to be the private-sector construction and operation of infrastructure (including Concessions) which would otherwise have been provided by the public sector. While the evaluation was under way, Eurostat published guidelines on when a PPP could be taken off the national “balance sheet”: there must be a transfer of risk to the private sector of both project completion and either project use or project availability. In practice, there was a high degree of commonality between projects meeting the definition used by EV and those conforming to the Eurostat guidelines.

Generally, but not exclusively, EIB PPP projects involve a project finance-style loan to a private-sector Special Purpose Vehicle (SPV) which has been set up to undertake the project. In all of the projects evaluated, the EIB loan was guaranteed during construction, usually by private-sector banks. In some cases, these guarantees were released once the project was proven to be operating satisfactorily.

There is clear EU support for the use of private funding for public infrastructure, including the use of the PPP mechanism, and for the EIB playing a major role in that process. By the end of 2003, the Bank had signed loans to the value of EUR 14.7 billion for PPP operations. However, eligibility for EIB funding is based on the underlying project, not the fact that it is a PPP. Further information on the Bank’s PPP operations may be found in “The Role of the EIB in Public Private Partnerships (PPPs)” which may be found at [www.eib.org/publications](http://www.eib.org/publications).

### Impact of the PPP Mechanism : On the Project

PPP structures are typically more complex than traditional public procurement of fixed assets, although traditional procurement’s apparent simplicity becomes more questionable when proper account is taken of the risks involved. PPP complexity is due to the number of parties involved and, particularly, the mechanisms used to share the risks. The funding costs of PPPs are also higher, reflecting : the impact of the risk being carried by the private sector, the cost of the additional loan structuring, and the private sector’s higher financing costs. For the public sector, this is compensated by the private sector accepting a proportion of the risks and, in certain cases, the acceleration of investment programmes otherwise subject to public sector borrowing constraints.

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<sup>1</sup> Relevance/Efficacy, Efficiency and Sustainability. See Appendix II for definitions.

The evaluation found that the underlying physical projects evaluated in-depth were largely completed on-time, on-budget and to specification. This reflected the use of fixed-price, fixed-term turnkey construction sub-contracts. These are common in PPP structures, but could also have been applied to public procurement. There was also evidence on some projects that the standard of the works was better than would have been found on a public procurement project.

In some cases, the Promoter was able to take advantage of a highly competitive construction market at the time of bidding, which produced cost savings. Conversely, restricted competition in one particular case meant that construction costs were probably some 30% higher than necessary. A cost risk which was noted was that implementing a large-scale PPP programme can raise demand for construction services in the short term, increasing bid prices at the given level of supply. This phenomenon has now been recognised as an important issue and administrations are trying to manage the flow of projects to ensure that the market remains competitive.

However, while these findings may be important for the management and availability of public infrastructure they are not critical for the assessment of whether, or when, to choose the PPP mechanism. Assuming that the same economic benefits will be realised, the question is which mechanism will provide the lower whole-life cost to the economy. A Public Sector Comparator (PSC) is intended to answer this question *ex-ante* but, *ex-post*, the evaluation could not quantitatively answer the question with an acceptable degree of certainty. The complexity of modelling the *ex-post* outcomes of the alternatives available *ex-ante* put this approach beyond the scope of the evaluation. Similarly, despite the EIB's large and diverse project portfolio, it was not possible to identify suitable project pairs to make a direct comparison. Under these circumstances, EV was unable to determine *ex-post* if the original decision to use a PPP was more cost-effective or not.

The evaluation found that the key impact of the PPP mechanism was that the projects were implemented at all. In all of the projects evaluated in-depth, public-sector budgetary constraints meant that the alternative to a PPP project was **no** project, or at least no project within the foreseeable future, rather than a public-procurement project. The extent to which government spending limits could have been adjusted to accommodate these projects can be debated, but almost all Promoters clearly stated that there would have been no budget for the projects as they were eventually implemented. In such cases, the use of a PSC may be questioned, and was applied to only a minority of the projects evaluated. However, there is a clear case for examining the underlying rationale of the project to test whether the project should be implemented at all, and carrying out a Value for Money (VfM) calculation to assess the economic efficiency of the proposed solution.

### **Impact of the PPP Mechanism : On the EIB**

The Bank can often be seen as having two clients on PPP projects. Initially, it is the public-sector Promoter, where the EIB may help to develop the PPP structure and a financing strategy. Following the calls for tender, it is the bidder who becomes the Bank's client. Bank staff handled this transition well, but it does add another dimension to their responsibilities.

Similarly, the Bank can have multiple clients during the bidding phase. All potential bidders have to be treated equally, which might mean developing financing proposals for a number of bidders in parallel. The Bank has no formal system of Chinese Walls or protocols on how the potential conflict of interests should be handled. The evaluation found that potential conflicts were handled on a case-by-case basis, rather than established processes, but all relationships were handled correctly and professionally.

The previously-mentioned complexity of PPPs makes them more demanding than traditional loans on staff resources, in terms of workload and duration. This was managed well where staff were devoting most of their time to PPPs, but was more difficult for staff working on a mixture of PPP and conventional projects.

Given the existence of third-party guarantees for the EIB's loans, at least during the periods of highest risk, none of the projects evaluated are likely to leave the EIB itself at significant risk of loss. This is particularly important in the case of projects where the Bank may, at some point, be exposed to direct project risk, which is dependent on the project satisfying predefined financial, technical and economic conditions.

### **Project Performance**

Of the ten projects evaluated in-depth, four were given an overall rating of "Good", four were rated "Satisfactory" and two could not be rated because they were at an early stage of operation. However, assuming a realistic level of traffic development, it can be reasonably assumed that they would qualify as "Satisfactory" in the future. No projects were given an overall rating of "Unsatisfactory" or "Poor".

All projects were rated Satisfactory or better against the "Relevance/Efficacy" evaluation criterion. Apart from one project where geological problems caused delays and cost over-runs, completion problems were due to either planning/environmental issues, inadequate project definition by the public sector, or problems in managing the interface between public- and private-sector elements of the same project.

The weakest ratings were against "Efficiency" of the underlying project. No projects were rated Poor for Efficiency, but two were Unsatisfactory, mainly due to traffic demand on road projects being lower than expected. All projects had been tested for their underlying economic value before being considered for investment, and these calculations were validated by the EIB's own appraisals. The Bank's sensitivity analyses typically tested scenarios which were more conservative than either the public-sector Promoter's case or the private-sector Provider's banking case, but in some cases the actual demand has been lower still. In most cases this was due to the economic growth of the country or region being lower than expected. On "Sustainability", only one project is giving cause for concern and is rated "Unsatisfactory".

### **EIB Impact and Value Added**

In newer PPP markets, EIB funding was often critical to whether or not projects proceeded – or if they had proceeded, it would only have been possible in a substantially different form.

All projects benefited from at least one form of EIB financial value-added, e.g., a lower cost of EIB funding, longer maturity or grace period, diversification of funding, etc. In some cases this meant that the public sector was able to increase the scope of its project. Conversely, there were also cases where the financial value-added only became significant when EIB released third-party guarantees. Prior to release, EIB participation actually increased the cost of the project. As guarantee release is conditional, the EIB financial value-added can therefore be contingent on the project performing properly.

The benefit of lower-cost EIB loans was not always passed on, either wholly or partly, to either the public sector or end-users. This was particularly true for some early PPP projects where the Bank only entered after a preferred bidder had been selected and the final bids had not taken into account the benefit of EIB funding. In all the projects evaluated, the availability of funding or financial value-added, including the provision of loans with maturities extending beyond those available from commercial banks, were the primary reasons for EIB involvement. If these had not existed, the EIB would not have been asked to lend for the projects. Having said this, all parties acknowledged that once the EIB was involved a number of ancillary benefits could be identified, such as :

- The Bank helped to "validate" projects, both by reassuring the public sector that an appropriate structure was being used, and by giving reassurance to private-sector lenders that the project had been reviewed by "another pair of eyes" whose expertise was generally recognised.



- EIB expertise in PPP structures and contract negotiations was generally valued by other project parties, but was particularly important in countries with limited experience of PPP operations. In addition to support given on individual projects, EIB staff have contributed formally and informally to the development of PPP policies in a number of countries.
- Public-sector partners valued the EIB’s presence as an “honest broker” and felt that the EIB, as a public organisation, would act in their best interests. The private sector sometimes felt that involving the Bank meant additional work, but respected the Bank’s professionalism and thought the Bank could play a useful role in persuading the public sector to adhere to the PPPs original intentions.

## TABLE OF RECOMMENDATIONS

	<b>EV Recommendation</b>	<b>Accepted Yes / No</b>	<b>OPS / PJ / RM /FI* Comments</b>
1.	In cases where the Bank does not enter at an early stage, e.g. single round bidding with a large number of potential bidders, it should make every effort to ensure that the funding cost advantage is passed on to the public sector or end user. (§8.1)	<b>Yes</b>	<p><b>Ops:</b> The principle that part of the EIB financial benefit should be passed on to the public sector/end users is accepted. Where this is not possible (for whatever reason) the non-financial benefits of EIB involvement (as highlighted, inter alia, in §8.2) also justify EIB participation.</p> <p>Early stage involvement in the PPP process is not always the most effective way to ensure the transfer of EIB financial benefit to the public sector/end-users as PPP procurement differs markedly across the EU. EIB value-added is maximised through a tailored approach to each PPP market.</p> <p><b>PJ:</b> Whenever possible, it is clearly desirable that the Bank's financial value added is shared by the public sector and/or users.</p>
2.	To manage PPPs properly, the Bank's procedures and systems need to be modified to suit: <ul style="list-style-type: none"> <li>• Multi-stage approval procedures;</li> <li>• Waivers;</li> <li>• Complex contracts and contractual relationships;</li> <li>• Multiple clients at appraisal.</li> </ul> (§5.2, §5.4, §5.6)	<b>Yes</b>	<p><b>OPS/PJ/RM:</b> Following Internal Audit recommendations, a joint Ops/PJ/RM/JU working group is reviewing policy and procedures for project finance deals, including PPPs.</p> <p><b>PJ:</b> PJ is preparing internal guidelines on the Appraisal and Monitoring of PPPs, including a review of the current 2-stage approval procedure and PJ's role in physical monitoring vis-à-vis RM during both construction and operation where the bank is at risk.</p> <p><b>RM:</b> This comment is mainly relevant where the operation is structured as a project finance operation.</p>

3.	<p>PPPs offer substantial opportunities for the Bank to add value. The Bank should therefore reinforce the existing Centre of Expertise (CoE) and consider establishing a horizontal Department with responsibility for structured finance operations including PPPs. (§5.6)</p>	<p><b>Yes</b></p>	<p><b>OPS:</b> agrees that PPPs offer the Bank opportunities to add value. It also agrees that PPP projects make more demands on OPS staff (in terms of time input and specialised knowledge) than traditional projects.</p> <p>The Bank can increase its value added and ensure a consistent credit quality in PPPs by sharing experience across countries: this underpinned the creation of The TENs/PPP CoE early 2004.</p> <p>Strengthening the CoE may be appropriate in due course to support country teams with a regular deal flow, and possibly to execute transactions in markets where the irregularity of deal flow precluded any accumulation of expertise.</p> <p><b>PJ:</b> PJ has put in place an internal PPP network to disseminate experience and good practice. This network is under the responsibility of a PJ Co-ordinator who liaises closely with the Ops Centre of Expertise.</p> <p>The creation of a horizontal PPP Department is an Ops matter. Allocated PJ sector experts remain within Sector Departments and retain their independent opinion on the economic rationale and financial viability of projects</p> <p>Further development in the Bank's role in advising on or even developing PPPs should be demand led, incremental and dependent on additional resources being available.</p> <p><b>RM:</b> RM believes this comment refers to loan origination. Within RM, operations are handled on a structural, rather than geographic basis. Therefore RM has no comments on this point.</p>
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4	<p>A number of Promoters would have benefited from guidance and support when variable rate funding was being swapped into fixed. Although not a traditional Finance Directorate role, the Bank could increase its value-added by offering such guidance to less experienced Promoters in the areas of swap pricing and competitive tendering procedures. (§8.1)</p>	<p><b>Yes</b> - where Promoters are inexperienced and/or do not have access to suitable advice.</p>	<p><b>FI</b> : . Sophisticated borrowers and experienced users of the PPP procedures would not normally need such support, and many project promoters already retain financial advisors for this purpose. For less sophisticated or experienced project promoters, more exotic currencies, etc., FI would be willing to co-operate with OPS on an ad-hoc basis, providing informal opinions on the pricing of swaps. This would not be on a fee-paying basis. The legal framework and the issues of subsidiarity and EIB policy would need to be reviewed and approved by the CD. However, if OPS believed this to be a value added service, then FI would certainly go through this type of approval process. <b>OPS</b> : Promoters on PPP projects normally employ financial advisors, and they are best placed to offer guidance and support to ensure that the swap pricing process is competitive.</p>
5.	<p>When approaching financial close, there is a need for the Bank's decision making to be as rapid and flexible as possible. The Bank should therefore review its approval process to allow increased delegation to the operational levels of the bank. (§5.3)</p>	<p><b>Yes</b> - to flexibility</p>	<p><b>OPS</b>: The use of the two-stage procedure – i.e. Board approval with detailed terms and conditions approved by Management Committee shortly before financial close provides sufficient flexibility. <b>PJ</b>: In preparing PPP guidelines, PJ will review how it could be more responsive to the realities of financial close deadlines. <b>RM</b>: This issue will be examined as part of the process referred to in Recommendation 2.</p>

\* Comments from directly relevant Directorates only

## 1. INTRODUCTION

This report presents the findings of an evaluation of “Public Private Partnership” (PPP) Projects financed by the EIB. In addition to assessing the performance of the projects against the Bank’s standard evaluation criteria<sup>2</sup> particular attention was paid to the impact of the PPP structure on the project and on the Bank, and to the Bank’s role in the process. The Evaluation was carried out in two stages: a desk review, followed by the in-depth review of a number of PPP projects.

### 1.1 Desk Review

The Desk Review was carried out between October and December 2003 on fifteen PPP projects financed between 1990 and 2001, of which fourteen are located in Member States and one in a partner country. This represented approximately half of the Bank’s PPP loans at the time, by number. Most of the projects chosen were physically complete, operational, had not been fully reimbursed, and were selected to provide a reasonable cross-section of the Bank’s overall PPP business as to country and sector. The analysis was primarily based on data and information held in the Bank’s central archive dossiers, supplemented by interviews with staff from the directorates involved. The main object was to identify the projects and the key issues to be examined in the in-depth phase. However, where appropriate, the findings of the Desk Review have been incorporated into this report, along with the findings of in-depth evaluations of PPP projects under previous EIB evaluations.

### 1.2 In-Depth Evaluations

Ten of the fifteen Desk Review projects were selected for evaluation in-depth, primarily through on-site meetings held between March and July 2004. These meetings included as many different parties involved in the individual projects as possible. Each had its own perspective on the project and the role the EIB had played. Typically, they included the Promoter and Provider, their financial advisers, other lenders or EIB guarantors, and the Provider’s lead investor. Meetings were also held with the government department responsible for PPP policy to review the project being evaluated in the context of the relevant country's general PPP policy development.

One of the in-depth projects is not located within the EU but was not treated separately due to the developed nature of the country's institutions and financial sector.

## 2. PPPs: A BACKGROUND

### 2.1 What is a PPP?

Put simply, a PPP is the provision, long-term operation, and maintenance, of public infrastructure by the private sector. However, this description also fits a range of other activities, including privatised utilities. The Bank has no formal definition of PPP itself so, for the purposes of the evaluation, a definition was established in consultation with the Bank's operational directorates: “A PPP should: have been initiated by the public sector - involve a clearly defined project – involve the sharing of risks with the private sector – be based on a contractual relationship which is limited in time – have a clear separation between the public sector and the Borrower.” This was the definition used to identify the portfolio of relevant projects (*cf.* §3.1) and potential projects to be evaluated.

During the evaluation, Eurostat presented guidelines on the accounting treatment of PPP projects. They did not provide a PPP definition *per se*; rather a set of criteria to define whether an investment should be “on” or “off” the national balance sheet. To be off-balance sheet, a PPP investment must involve the transfer of risk to the private sector of both project completion and either project use or project availability. All except one of the projects evaluated in-depth would have satisfied the Eurostat tests. However, it should be noted that the Governments concerned have not necessarily accounted for the projects in this way. The Bank has recently published a

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<sup>2</sup> Relevance/Efficacy, Efficiency and Sustainability. See Appendix III for definitions.

paper: “The EIB’s role in Public-Private Partnerships (PPPs)<sup>3</sup> which gives a useful summary of this issue, as well as a general overview of EIB involvement in lending to PPPs.

## **2.2 Historical Perspective and Current Directions**

Private-sector involvement in public infrastructure is not new. Historically, toll roads, bridges, canals, schools, railways, hospitals, etc. were normally outside the public sector. What PPPs are complementing, or replacing, is a system of ownership and operation which largely developed in the nineteenth and twentieth centuries.

The current developments in PPPs have been driven by a general move to the application of market disciplines and the involvement of the private sector. The growth of the PPP can therefore be seen as a parallel process to privatisation and outsourcing; lying somewhere between the two. At the policy level, this move has had widespread political backing. However, it can also be argued that the growth of PPPs is due to a growing gap between investment needs and available public resources. There are two dimensions to be considered: “quality”, that what is delivered is better, and “volume”, that more can be delivered earlier. The first of these is obviously a desirable attribute for all investments. The second is less certain. Gaining economic benefit early is desirable, but only if later projects with greater through-life benefits are not displaced.

It is difficult to describe a typical PPP, because they are so diverse. However, as an introduction to the vocabulary – to be extended in §2.4 – a PPP is a long-term contract between a **public-sector Promoter** and a **private-sector Provider**. Under this contract, the Provider will typically arrange the funding for the project, build the asset that the Promoter has specified, operate and maintain it, and hand it over in good working condition to the Promoter at the end of the contract. In return, the Provider will receive either direct payments from the end-users or be paid to provide the service by the Promoter.

## **2.3 PPPs vs. Public-Sector Procurement**

As will be seen in §2.4, PPPs are complex structures and complexity normally means higher costs. The question is whether these extra costs are outweighed by any PPP quality and/or volume benefits. When choosing between a PPP and traditional public procurement, there are a number of issues to be considered :

Capital Budget Traditional public procurement investments depend on the availability of an appropriate capital budget. If capital budgets are constrained, it may not be possible to implement economically desirable investments. PPP investments are less dependent on capital budgets and may be “off-balance sheet” depending on the balance of risk between the public and private sectors.

Recurring Budget In a PPP, the private-sector Provider needs to be paid – either by end-users through real tolls, or by the public-sector Promoter through shadow tolls, asset availability fees, etc. These payments have to cover the costs of funding the project, plus Operating and Maintenance (O&M) costs.

Risks There must be some sharing of risk in a PPP, e.g. project completion risk (costs/time/specification), operating risk (demand/operating/performance/continuing quality), etc., and the Provider has to be paid a premium to accept these risks. The argument is that the private sector is better at managing some of these risks than the public sector and therefore the risk premium is lower than the cost to the public sector of carrying the risk itself.

Complexity Premium A PPP is an inherently more complex operation than public procurement. Some countries, e.g. the UK, carry a higher “complexity premium” than others, e.g. Spain. The argument is that private-sector disciplines will generate sufficient savings to offset the complexity premium, at least in the longer term, once the parties are fully experienced and standardised methodologies and documentation have become available.

Skills Transfer It is argued that the public sector should benefit from exposure to the skills of the private sector.

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<sup>3</sup> the paper may be found at [www.eib.org/publications](http://www.eib.org/publications)

**Flexibility** PPPs are normally less flexible than traditionally procured projects and may therefore be better suited to projects where the public sector does not anticipate frequent or substantial changes to the asset specification or how it is used, e.g. roads.

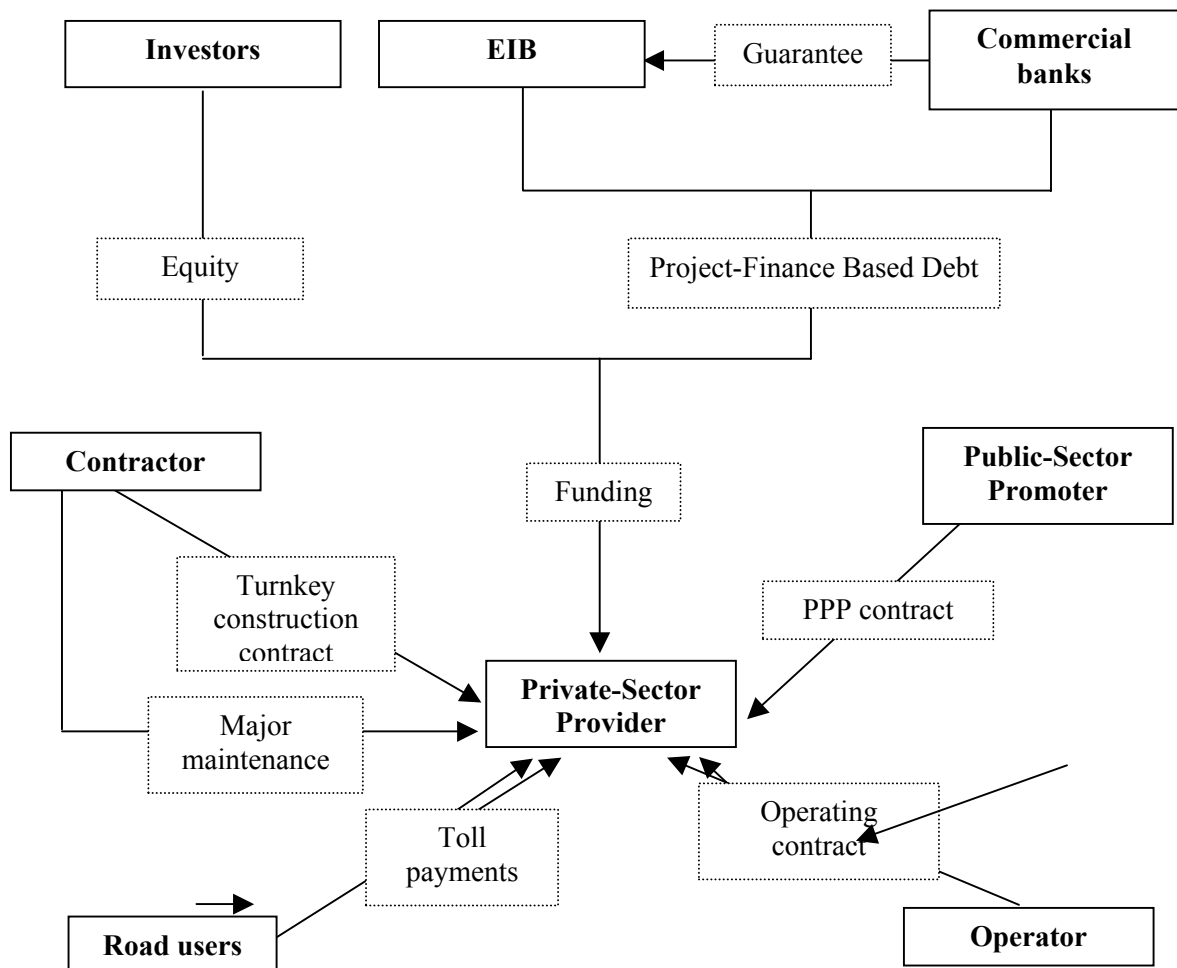
**Innovation** PPPs can bring innovation through the private sector finding new ways of achieving “output” targets, as opposed to meeting “input” or “design” specifications which normally form the basis of public-procurement contracts.

It is clear from the above that any rational decision between PPP and public procurement will involve a complex analysis. It is further complicated by the need to consider a range of non-project issues, e.g. the maturity of the financial sector, taxation, level of sophistication of potential bidders, etc.

One option is to apply a common, structured decision tool such as a Public Sector Comparator (PSC). A typical PSC will compare the likely costs and benefits of the two processes and generate a Net Present Value for the public and PPP cases. However, the PSC approach can be rather artificial and, in practice, it is used in relatively few countries.

Whether or not a PSC is used, or any other test for Value for Money (VfM), it is clear that using a PPP does not change the fundamentals of the underlying project.

#### 2.4 PPP Structures



The diagram above sets out the outline structure of a typical EIB PPP project: a road project where users pay tolls. It should be noted that the complexity is not due to the PPP mechanism *per se*. It is generated by the risk mitigation mechanisms and the use of project finance to fund the project.

Most of the blocks are self-explanatory, but to clarify:

#### Contractor/Operators

The Provider usually sub-contracts the construction of the project on a fixed-price, fixed-delivery basis. This transfers some or all of the project risk to the subcontractors. Like the Provider, these are typically unincorporated joint ventures, with some or all of the shareholders in common with the Provider. It is also quite common to subcontract O&M of the PPP as well. These subcontractors may be specialist suppliers or, again, SPVs with one or more shareholder in common with the Provider.

#### Funding

Typically 10-25% of a PPP's capital costs are funded by equity or subordinated debt from the Provider's shareholders, and the balance from external debt finance. Apart from the EIB itself, debt finance may be provided by commercial banks or, in some cases, by the bond market.

In most PPP transactions, the physical asset, *e.g.* a road or a school, cannot be pledged as security and, as noted above, the Provider is usually an SPV. Security for the debt funding therefore cannot be based on either the Provider's balance sheet or the value of physical assets. Instead, project finance techniques are employed, based on the project's cash flow. This takes account of the risks assumed under the PPP Contract, combined with limitation of these risks through the various sub-contracts. Limitation of risk is important to enable the Provider to raise a high ratio of external debt for the project, which - since debt is assumed to be cheaper than equity - reduces the cost of the project to the Promoter.

### **2.5 Risk-Sharing**

The key to the PPP process is the sharing of risks between the parties. In allocating risk, it is a general principle that risk should be carried by the party which is best able to control, manage, or mitigate that risk. Considering the various stages in the PPP process after the final bidder has been selected:

#### Funding Risks

*Failure to reach financial close*, which is largely carried by the Promoter. A winning bidder who cannot reach financial close will probably suffer a significant financial loss, as well as a loss of reputation. However, it is the Promoter which has to deal with the consequences of the failure. The Promoter normally mitigates this risk either by inviting bids only from well-established and qualified bidders, or by making it a bid submission condition that the bidder can demonstrate that it has funding available.

*Interest-rate movements between the submission of bids and financial close*, which is carried by either the Promoter or the Provider, depending on the terms of the bidding.

#### Completion Risk

The risk that an asset can be designed and built on-time, on-cost and to-specification. These risks should clearly be the responsibility of the Provider who should have the appropriate skills and experience to mitigate them. The public sector could mitigate these risks on its own projects by employing the same device as the Provider, *i.e.* the fixed-time, fixed-cost, fixed specification turnkey contract. However, historically it has not used this type of contract and public-sector procurement has a history of large capital-cost overruns.

#### O&M Risks

There are two key elements. Firstly, that the asset's maintenance requirements will be different to those predicted and secondly that there will be a difference in unit cost of maintenance. Both the potential upside and downside of these risks is transferred to the private sector. The Provider should therefore have an incentive to produce an asset with the lowest whole-life cost - or at least the lowest cost until it is handed back to the Promoter.



### Termination Risk

This risk does not apply to traditional public procurement and is borne both by the Promoter and the Provider. It is the risk that the PPP arrangement will be terminated early, either through the Provider failing financially or failing to perform technically, e.g. by not providing the contracted service adequately. This is a risk for the Provider as it will almost certainly suffer a material financial loss on termination. However, it is also a risk for the Promoter: it will still need to arrange for the service to be provided after the termination, based on the available, constructed project. The risk can be partially mitigated by selecting suitable bidders. However, these are long-term contracts and there is a trend for the original technical members of a consortium to be displaced by purely financial investors which may not have the relevant experience and expertise. Provider failure, on the other hand, may be due to an inappropriate allocation of risk from the outset: see Revenue Risk below.

### Revenue Risk

The Provider can be remunerated in three different ways, each of which carries different risks.

- Direct payments, e.g. tolls on roads/bridges, treatment fees for waste management, etc.
  - Risk The level of the tolls or fees can be negotiated but the level of available traffic, and hence revenues, is usually beyond the control of the Provider.
- Indirect payments, e.g. shadow tolls on roads.
  - Risk Payments to the Provider may depend on volume but shadow toll and fee structures can be designed to minimise the risk to the Provider, while limiting windfall profits from large increases in utilisation or demand.
- Availability payments, e.g. for schools, hospitals, or physical transport infrastructure.
  - Risk Availability payments are based on the asset being available for use, with penalties for failure to perform. This is under the Provider's control, so the risk should be carried by the Provider rather than the Promoter.

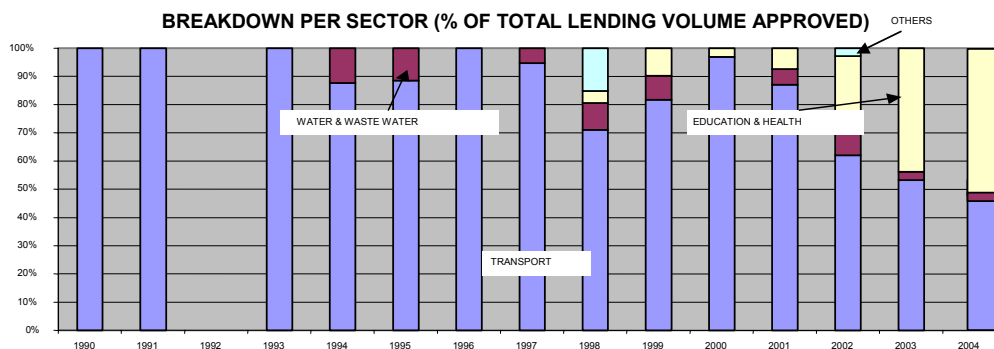
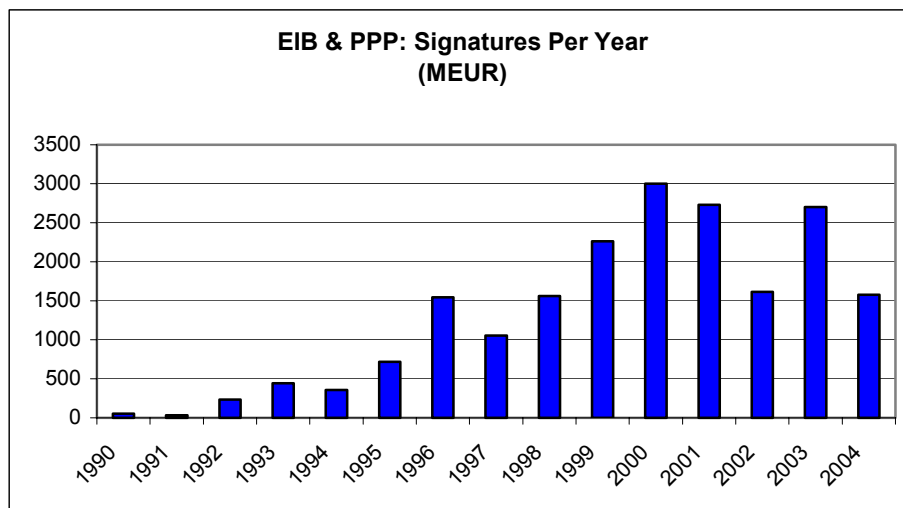
A fourth possibility is a mixed-payment regime, involving a combination of availability- and traffic-based payments.

## **3. PPPs: EIB INVOLVEMENT**

### **3.1 *The Portfolio***

The EIB's PPP exposure may be traced back to the loans made in 1987 to Eurotunnel (France/UK), in 1989 for the Orlyval project (France), and in 1992 for the Second Severn Crossing project (U.K.). These projects offered the Bank the opportunity to learn a number of valuable lessons. At the same time, project-finance lending techniques were being developed through the Bank's involvement with private-sector project finance deals in power industry in the U.K. and elsewhere. A breakdown of the Bank's portfolio by sector can be found in Appendix I.

The main growth in the portfolio began with loans to projects under the UK Private Finance Initiative (PFI). The UK PFI dates back to 1992, but has developed rapidly since 1997 and similar schemes have been adopted in many other EU Member States. The Bank is now lending to PPP projects in Belgium, Denmark, Germany, Spain, France, Greece, Ireland, Italy, Netherlands, Austria, Poland, Portugal and the U.K., as well as in non-Member States, e.g. China and South Africa. The EIB is one of the largest individual lenders to PPPs, by volume, within the EU. An outline of the growth in the Bank's PPP operations, and a breakdown by sector is presented below. Further information can be found in "The EIB's role in Public-Private Partnerships (PPPs)".



### 3.2 Policy Framework

**EU Policy:** Historically, the EU has been neutral as to ownership of assets, *e.g.* there has been no policy on privatisation. However, in addition to a policy on deregulation of public services, there has been, since 1999, a clear policy from the European Commission to increase the level of private funding of infrastructure, *e.g.* in the transport sector, and the PPP structure is one way of achieving that policy objective. The use of the PPP mechanism was also endorsed by the Council of European Union meeting of December 2003.

**EIB Policy:** Most International Finance Institutions (IFIs) and Development Finance Institutions (DFIs), *e.g.* World Bank and EBRD, have policies which actively promote the PPP mechanism. The Bank, on the other hand, reflects EU policy on how public projects are procured, and has no preference as to whether a project is implemented using conventional public-sector procurement or *via* a PPP. The Bank may be perceived as supporting the use of PPPs, but its actual position is one of neutrality between the two procurement mechanisms. Its involvement in PPPs is a reflection of how a number of its clients want to procure their projects. Similarly, “PPP” is not an eligibility criterion for the EIB. Eligibility is based on the underlying project, and the Bank’s normal eligibility and project quality tests are applied.

**National Policies:** There is no common policy between EU member states on the desirability of the PPP mechanisms. Some countries, *e.g.* the UK and Spain, have made substantial use of the mechanism. Others have not used it at all. Projects supported by the Bank have to have the consent of the relevant Member State government and it must be assumed that any PPP project receiving this consent is in line with national policies.

## 4. PPPs: THE IMPACT ON PROJECTS

### 4.1 *Why Use a PPP*

In all the projects evaluated in-depth, the main reason for choosing the PPP route was to launch investment programmes which would not have been possible within the available public-sector budget, within a reasonable time. Other benefits may also have been anticipated from using a PPP but were not critical to the decision. In two cases, the Provider actually took over significant amounts of public-sector debt which had been previously incurred in building part of the project.

This does not imply that PPPs are nothing more than a device to limit government borrowing:

- PPPs involve a genuine sharing of risks between the public and private sectors.
- In most cases the PPP approach enabled the public sector to accelerate the construction of key infrastructure, to the economic benefit of the country concerned, and usually with ancillary environmental or social benefits. The EIB's own analyses of these projects confirmed this benefit.
- The growth of PPPs is part of a wider change in the role of the state from a direct provider of services to that of a facilitator and regulator of these services.

On the negative side, as well as possibly increasing costs, it can be difficult to build flexibility into PPP Contracts, and changes may be expensive. This makes them less suitable for projects which will be affected by, *e.g.*, policy or demographic changes. This is demonstrated by a transport project. Although change was anticipated from the outset, the actual process has been slow and expensive. The Provider is in the position of a preferential, if not monopoly, supplier and the contractual arrangements are complex.

### 4.2 *Negotiations and Contractual Issues*

The PPP projects evaluated in-depth were more complex than they would have been under public procurement, and posed new problems for the public sector.

#### Contract Negotiation

A public-procurement award of a contract has to deal with the timing and specification of the physical works. PPPs, on the other hand, also have to deal with revenue, O&M and termination issues. The public sector may also be at a disadvantage during contract negotiations. An individual Promoter will only rarely have to negotiate a PPP contract, while the Provider is negotiating regularly. There may also be an issue of asymmetry in the quality of advice available to the public and private sector.

#### Intercreditor Issues

Reflecting the additional work for the EIB laid out in §5.4, PPPs impose a much higher workload on both the Promoter and the Provider. Referring to the diagram in §2.4, all of these contractual relationships have to be formalised. This can be both time-consuming and expensive. However, as the process develops this “complexity premium” reduces: contracts become standardised and the parties learn to handle the relationships.

### 4.3 *Project Implementation*

#### Costs and Delays

One of the arguments put forward in favour of PPPs is that they are more likely to be on time and on budget. The evaluation therefore sought to test whether this was true and, if not, were delays due to the Promoter, the Provider, or outside factors? On the transport project referred to above, there were long delays in agreeing detailed project specifications with the Promoter, which delayed completion and increased costs. Similarly, there were delays and cost overruns on a road infrastructure project, due to a combination of geological problems and slower than expected civil works. There were cost overruns, but no delays, on three projects: an urban motorway (mainly on the public sector element of the project), an inter-city motorway (the Provider decided to build an extra lane on the motorway), and a second road infrastructure project (due to a combination of restrictions on the civil works, and the need to carry out additional work for safety reasons). The extra costs on both road infrastructure projects were carried by the Promoter.

There are also potential issues where the Provider is controlled by construction companies which may look for short-term benefits at the expense of long-term costs. On a motorway and a road infrastructure project, the Providers are led by contractors and the scope of the construction work may have been expanded prematurely. On the motorway, this was carried out during construction and without prior lender consent. In the case of the road infrastructure project, additional works were correctly included as part of the bid. These additional works benefited from economies in construction, but the Providers now have to carry a greater debt burden, without sufficient revenues to fully support them at this stage.

#### Potential PPP Advantages

Two of the Promoters of the projects evaluated, specifically referred to histories of public-sector cost overruns as a major additional reason for going down the PPP route. The evaluated projects avoided such problems, but this was not because they were PPPs. Rather:

- The Promoter specified its requirements for the project and kept to this specification. In almost all cases of cost overruns and delays which were not caused by exogenous factors, the reason was changes in the technical specifications or work scope after the contracts have been awarded.
- The Provider subcontracted construction to a construction company, often a shareholder in the Provider, on the basis of a fixed-price turnkey contract.

These benefits can be realised in conventional public procurement if the public sector applies the same discipline on specifications and uses fixed-price turnkey contracts. However it is often difficult to replicate the external discipline imposed by the PPP due-diligence process, *i.e.* from lenders such as the EIB, or to have the in-house skills needed to administer this type of process.

There may also be economies of scale from the PPP route if it enables projects to be undertaken in larger units—*e.g.* a group of buildings rather than each building being procured individually, or a road procured as one complete project rather than split into sections.

#### Potential PPP Disadvantages

- The fixed-price turnkey construction contracts used in PPPs appear to be more expensive *ex-ante* than standard quantities-based contracts – because not only are the contractual arrangements more complex but the contractor is pricing in the risk of cost overruns, and penalties for late completion. The question is whether the additional costs are compensated by savings later, so that the cost is lower *ex-post* than it would have been under traditional procurement.
- The additional skills and financial resources needed to set up a PPP may restrict the potential bidders, reducing competition and increasing prices.
- Using PPPs to accelerate a large-scale construction programme may, in some cases, create an increased demand for construction work which itself pushes up prices.
- The time taken to set up the contractual arrangements for a PPP, and to reach financial close, may increase the project implementation time.

On costs, the Promoters of two of the projects evaluated in-depth stated that there was no significant cost disadvantage from using the PPP route, and that there may have been cost savings. However, on one particular motorway project, the small number of eligible bidders almost certainly resulted in a bid price which was higher than necessary. Similarly, in one EU member state, removing the public sector budgetary constraint appears to have led to a road-building boom which resulted in increasing prices.

Referring to a range of previous EIB evaluations, some fifty public infrastructure projects were identified which had used public procurement. On project delays, 60% of projects were more than one year late, which is poor in comparison to the PPPs included in this evaluation. This figure is similar to the finding of an analysis carried out by the National Audit Office of the UK.

## Conclusion

Only one project appeared to have higher costs than the public procurement alternative, and that was probably due to a lack of competition, rather than complexity. Conversely, on two other projects, a trunk road project and a road infrastructure project, the availability of the PPP option meant that bidding took place against a depressed construction market, producing very tight pricing. The use of standardised contracts, etc., should bring down the “complexity cost” but, even now, there is probably no substantial cost disadvantage to the use of PPPs in the real world. The evaluation supports the premise that, *ex-post*, PPPs are more likely to be on-time and on-budget.

### **4.4 Project Operation**

#### Operating & Maintenance costs

In some EU countries, the public sector has a poor track record in the maintenance of its infrastructure and buildings. In all cases, the in-depth projects had been completed to a standard at least as high as normal public procurement would have provided, and two Promoters specifically commented that the quality was better than expected. Maintenance costs should therefore be no higher, and possibly lower, than the public procurement alternative. The rationale is that the infrastructure or buildings will be designed for efficient long-term use, because the Provider's return is based on their operation and maintenance. The Provider will also face penalty charges if it fails to hand over a fully functioning asset at the end of the Contract. The standing of maintenance is reinforced by two PPP characteristics. Firstly, the Promoter's budget is pre-committed to the Provider, so maintenance does not have to compete with other demands. Secondly, detailed maintenance requirements are specified in all types of PPP Contract, therefore short-term budgetary constraints within the Provider should not affect maintenance standards. Similar budget arrangements could be applied to traditionally procured projects, of course, but would be difficult to realise in practice. Since the projects evaluated were all quite new, no conclusion could be drawn on whether these long-term benefits would materialise.

#### Revenues

In cases where there are problems with project revenues as compared to the original projections, these are occurring in projects where the Provider is bearing usage risk, *i.e.* the road projects with “real” - user-paid - tolls. The evaluation included five projects of this type. On two of them, traffic is either at, or above, the original projections. On the other three, traffic is below projections. The “hit rate” is therefore quite poor, although all the roads are at an early stage of operation, and long-term trends may improve. This result is similar to the findings of the evaluation “EIB Financing of Urban Development Projects in the EU”, 2003, [www.eib.org/publications](http://www.eib.org/publications), where opening year traffic in eight out of eleven projects was below forecast. Evidence from other transport studies shows that there is typically a gradual increase of demand over the first one-two years of opening. However, five of the eleven urban development projects still suffered from traffic which was lower than forecast after that period.

There is a risk that the pricing on a real-toll road inhibits the use of the infrastructure. PJ expressed concern about this on one project in a relatively less developed region of the EU. The evaluation did find that the traffic was below expectations, but it is too early in the operation of the project to reach any firm conclusions. Two projects evaluated in-depth for other evaluations, found that “willingness to pay” was a serious issue. In one of those cases, social and political pressure to reduce the level of tolls led to the renegotiation of the PPP contract. In another EIB-funded project, the same issue has led to the Promoter “buying out” the Provider's rights under the PPP contract. In the one shadow-toll project evaluated in-depth, the traffic is below the Provider's projections, but this is not a major issue because the structure of the shadow-toll payments is such that even a significant drop in traffic does not affect revenues. The Promoter, rather than the Provider, is taking most of the traffic risk. In this case the Promoter is not concerned by the current traffic levels: they are close to its original projections, which were lower than the Provider's.

The projects based on availability, where revenues depend on providing the service as specified, are all meeting revenue projections.

## Conclusions

One, or even more, Providers may not be financially sustainable in the long term. However, the underlying projects are technically sound, and the economic benefits they produce are independent of the ownership of the assets. In most of the projects evaluated, the failure of a Provider would involve either the Promoter taking over the project itself or re-tendering the operation and management of the project to a new Provider. There would be costs associated with either of these options, but the Promoter would probably still be better off than if they had carried out the project using public procurement. The private-sector shareholders will have lost their investment, but that possibility is inevitable and it was a free decision on their part to accept the risks involved.

### **4.5 Other Relevant Issues**

Tax - A PPP generates more tax revenues than public procurement: there are long-term revenues from the Provider's equity investors and lenders. Although they may not benefit the Promoter directly, and may be difficult to quantify, these extra tax revenues can be set against payments by the Promoter when evaluating net cost to the public sector.

Innovation in design and operation of a project - The Promoter defines a specified output, but it is normally the Provider who determines how it is delivered. It was probably too early to find evidence of innovation in operation of the projects evaluated, although on an education project a number of O&M developments had been introduced which might have a wider impact on how educational infrastructure is managed. However, there is no obvious medium through which these benefits might be disseminated.

Introduction of private-sector management and implementation skills to the public sector, e.g. in areas such as keeping projects to schedule, or better service quality in operations. No evidence was found to support this, and it is possible that the use of PPPs may result in a transfer of technical skills from the public sector to the private sector.

The external discipline imposed by lenders. In several of the projects evaluated, both Promoter and Provider agreed that intervention by the lenders, including the EIB, in the PPP Contract and subcontract negotiation processes produced a better deal.

Joint public-PPP projects – For a rail transport project evaluated in-depth, the Promoter is constructing the infrastructure to which the Provider's works will be added. Balancing the demands of the public sector and PPP sides of the same project have become a major issue for the Promoter.

### **4.6 PPPs vs. Public Procurement – Evaluation Findings**

As stated in §4.3, there is clear evidence from this evaluation that PPPs are more likely to be on-time than public procurement projects. Other studies have come to the same conclusion. Similarly, provided there is no change in the project definition, and assuming the Provider is carrying the completion risk, there would normally be no additional costs charged to the Promoter. However, while these findings may be important for the management and availability of public infrastructure, they are not critical for the assessment of whether, or when, to choose the PPP mechanism. Assuming that the same economic benefits will be realised, the question is which mechanism will provide the lower whole-life cost to the economy. This is, of course, the question that PSCs are designed to answer *ex-ante*. However, *ex-post*, the evaluation could not quantitatively answer the question. Two methodologies were considered: the *ex-post* modelling of the alternatives available *ex-ante*, and direct project comparisons. The modelling approach was rejected for two reasons. Firstly, because of the level of uncertainty associated both with the risks being transferred and the behaviour of the public sector. Secondly, the resources needed to carry out this work on a reasonable number of projects placed it beyond the scope of the evaluation. The direct comparison approach also had to be rejected. To make an effective comparison it would be necessary to identify two projects of similar specification, constructed and operated in the same legal, financial and fiscal framework, and subject to the same market conditions. Although the EIB has a large and diverse portfolio, it was not possible to identify suitable project pairs. Under these circumstances, EV was unable to determine *ex-post* if the original decision to use a PPP was more cost-effective or not.

## 5. PPPs: IMPACT ON THE EIB

### 5.1 *Project Identification and Selection*

In PPPs, the Bank uniquely has two clients: the Provider - normally the Bank's borrower, and the Promoter - a public-sector institution. This potentially gives the Bank two roles: lender to the Provider, and mentor to the Promoter, who may have much less experience in PPPs than the Bank. This situation arises particularly where the Bank gets involved in projects at an early stage, and there is obviously potential conflict between these roles. Initially the Bank may be sitting on the Promoter side of the table helping to define and shape the project. It then moves to the Provider side, sitting opposite the Promoter, to help negotiate the PPP Contract which is the main security for the Bank's loan. The Bank, as a public-sector institution, may therefore find itself in the situation of seeking to negotiate a contract which is in its financial interest, but which may not be in the best interests of the Promoter/Public Sector.

### 5.2 *Project Appraisal*

#### Procurement

PPP projects have to follow the same EU and EIB rules as public-procurement projects. In some cases Providers also had to follow EU procurement rules for sub-contracts - where the Provider is not owned by a contractor.

Two different EU procurement procedures were used in the projects evaluated, and the choice of procurement procedure affected how and when the EIB entered the project cycle:

- Restricted procedure - The Promoter invites bids for the PPP contract from a pre-qualified list of bidders, and there is no negotiation after bids have been submitted. In these cases, the Bank did not make financing terms available until after the appointment of the preferred bidder. The EIB financing benefit could therefore only be reflected in the bids if the bidder was prepared to take the risk of EIB funding being available. This also applies to the one round negotiated procedure (see below).
- Negotiated procedure – This can take two forms:
  - One round of bidding Pre-qualified bidders make submissions, after which the Promoter enters into detailed negotiations with a preferred bidder. EIB financing terms were not made available until after the appointment of the preferred bidder.
  - “Best and Final Offer” (BAFO) Again, pre-qualified bidders make submissions, after which the Promoter may negotiate with a shortlist of two or three bidders which are invited to submit their “BAFOs” in a second round. This approach was used in majority of projects evaluated in-depth. The standard EIB procedure was that the project would be given an initial credit approval during the BAFO preparation phase, based on assumed terms and structure. Outline financing terms were then provided to all BAFO bidders simultaneously. Final credit approval was obtained after the detailed terms had been negotiated with the preferred bidder after the BAFO stage.

Exceptionally, in the case of the rail infrastructure project referred to above, final credit approvals were given for both BAFO bids. This followed a specific request from the Promoter who believed that this would offer the most competitive bidding. A form of “Chinese Wall” was set up between two teams in OPS, but with both teams reporting to the same Head of the Department. The Promoter appreciated that this procedure doubled the EIB's work but was happy to pay the extra costs to achieve the best deal. On other projects, bidders wanted an “arm's length” relationship with the EIB, because they knew the Bank was also talking to competitors. This suggests that the best possible EIB terms might not have been fully taken into account. The parallel appraisal procedure has not been repeated. If it did produce a significant benefit, then the EIB could consider more involvement with bidders during the tendering phase. This example does demonstrate how the Bank has been prepared to modify its relationship with Promoters on a case by case basis, but the benefits may not justify the substantially higher demands on the Bank's staff resources which this particular approach requires.

### Public Sector Comparator (PSC) and Value for Money (VfM)

Only the projects in two countries had been the object of a formalised PSC process, although a third had used an *ad hoc* system. The Bank did not normally review the PSC, although the assumed cost and benefit figures were often used for the Economic Return (EIRR) calculation. However PJ economists said that they would encourage the Promoter to make use of a PSC in its own review of alternatives. The Bank did not normally consider whether a particular PPP structure offered VfM compared to other possible structures. The exception to this was a motorway project, in which PJ carried out a VfM exercise which showed that, in economic terms, the chosen structure was not the best option. It is also notable that a PSC was not used for one country's motorway programme, and a subsequent review by the national audit office pointed out that the programme had not been preceded by an assessment of VfM.

### **5.3 Approval Process**

The Bank's normal loan approval procedure is that the Management Committee accepts a proposed loan operation from the lending departments and recommends it to the Board of Directors, which, in turn, approves the actual loan operation. The exception to this procedure is the use of a two-stage approach, e.g. where the procurement is based on a BAFO stage:

- The Management Committee initially recommends the loan to the Board of Directors, based on OPS' analysis of the likely credit structure of the project and all of the BAFO bidders, and PJ's techno-economic analysis.
- If this proposal is approved by the Board, authority to approve the final details is delegated to the Management Committee.
- Once the Provider has been selected and the deal is approaching Financial Close, the final deal is re-appraised by OPS, PJ and CRD and a Final Note to the Management Committee is prepared. If the operation is satisfactory, the Management Committee has the power to authorise OPS to negotiate the final contracts.

This should be an efficient and reasonable procedure. However, in practice, the Board of Directors often has to take its decision based on limited information about the risks the Bank will be taking. The Board often does not know:

- The terms of other finance being provided to the Provider;
- Key risk issues such as the amount of standby debt or equity funding;
- The financial value-added<sup>4</sup> of EIB funding;
- The extent to which the financial benefit would be passed through to the public sector.

In a commercial bank, the credit decision would normally be taken by an operational credit committee, or by a named individual or hierarchical position under delegated authority. Decisions are taken very close to the operational level which is negotiating the loan and guarantee structures. Within the Bank, the Management Committee, which will make the credit decision on BAFO deals, is hierarchically separated from the operations staff and meets weekly. The Board, which takes all other credit decisions, is made up of non-executive Directors and meets ten times a year. On PPPs, the period running up to financial close is very time-sensitive. It might therefore be desirable to increase the degree of operational flexibility. The Bank employs well-qualified, responsible, experienced staff thus, always within a prudent credit framework established by the Board and Management Committee, the delegation of some decisions could make the process more effective and efficient.

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<sup>4</sup> Procedures have now been established to quantify the value-added and a standard fiche will be presented to the Management Committee for all proposed loans after September 2004. However, this only tracks the financial value-added to "the Customer", which for PPPs is the private sector. It does not identify what proportion of the financial benefit is going to the public sector.



#### **5.4. Negotiations and Contractual Issues**

##### Documentation

The extent to which the EIB was involved in negotiation of project documentation depended on when the Bank became actively involved with bidders. When the Bank came into the cycle late, as in the restricted procedure, it played no part in negotiations. However, where it was involved:

- The Bank was recognised as having made a positive contribution to the negotiations. Several financial sector players praised the commitment and quality of work done by Bank staff. The Bank could often be the most experienced lender at the table and experienced commercial bankers commented on the EIB's professionalism in the PPP field.
- Promoters also strongly valued EIB's contribution in new PPP markets, and the Bank helped to avoid "polarisation" between the public and private sectors. Promoters believed that the Bank would treat them fairly, while other lenders were also happy to use the Bank as an intermediary to make their views clear to the Promoter. The Bank sometimes also restrained other lenders from taking extreme positions. On the other hand, some Promoters took the view that the EIB should be treated at arm's length like the other banks.
- EIB-related difficulties were primarily due to the differing agendas of the EIB and commercial banks, in particular as to the economic viability of the project, or its linkage with other projects with which the EIB was involved. This was often seen negatively, although it could be positive for the project, *e.g.* the Bank's desire to develop a section of motorway because the Bank had already financed a central part of the route, which would not be viable without the connecting roads on either side.

##### Inter-creditor Issues

In PPPs, the Bank usually lends in parallel with commercial banks and there needs to be agreement on how decisions are to be coordinated (a) when the EIB is guaranteed by the commercial banks but will assume risk on the project in due course, and (b) when EIB has assumed risk on the project. This process evolved during the time of the projects evaluated, but the typical final position reached was that:

- all decisions are taken by the commercial banks while the EIB is fully guaranteed, but the EIB has the right to refuse to release their guarantee if it is not satisfied with these decisions;
- once the EIB is on-risk, all decisions require the consent of both the commercial banks and the EIB separately.

This structure means that the EIB, which is usually the largest single lender, has an appropriate say in lenders' joint decisions.

##### Termination Issues

The risk of a termination of the PPP Contract on Provider default was generally analysed, but the level of potential loss for the Bank usually did not appear in the appraisal reports. In such cases the possibility of loss depends on the termination-payment provisions in the PPP Contract, which may range from a zero payment by the Promoter to a potential full recovery of debt.

#### **5.5 Project Operation**

There is a continuing relationship between the Bank and the Provider once the project has passed into the operational phase. The job of managing this relationship lies with RM, which is responsible for monitoring the transaction's credit risks, using the independent Technical Assistance (TA) available to all senior lenders. The long-term nature of the relationship with the Provider was not always recognised by PJ, with the exception of a particular education project. Other PJ appraisals did not take into account the fact that the project included long-term maintenance risks. PJ engineers agreed that this had been a problem in the past, but said the issue was considered more carefully now. This obviously becomes a more important issue where the Bank releases some or all of its guarantees once the project is operating, and is therefore taking long-term maintenance risks.

## 5.6 PPPs: Organisational Issues for the EIB

The EIB now generally treats PPPs as a sub-set of project finance, even where the Bank is fully guaranteed throughout. This, and the more complex nature of PPP operations, implies a different set of working procedures and relationships compared with conventional projects.

- It can be difficult to undertake structured lending in parallel with “plain vanilla” loans, as the balance and pace of work are so different. This is not a problem for OPS and RM, where Loan Officers and Credit Analysts may either be dedicated to this type of operation or can devote a substantial part of their time to them. However, it can be a problem for the other Directorates, particularly PJ. There is also an issue that monitoring during construction, a traditional role for PJ, seems to be largely carried out by RM using the independent advice referred to above, rather than PJ resources. Post-completion, when commercial banks continue to employ technical advisers, PJ has tended to fade out of the picture.
- Suitable expertise is not available in all regions and expertise on PPPs developed in one region is not necessarily fully used elsewhere. *Ad hoc* solutions for this have been developed, e.g. the team from one country department was actively involved in appraising a project in another country, and staff transfers take place. The recent creation of “Centres of Expertise” within OPS is a step towards the better integration and availability of PPP and PFI expertise. However, the case for a structured-finance department has been accepted by all major commercial banks and, in one way or another, by other major IFIs, but not by the EIB.
- OPS and PJ normally set up a joint project team to consider PPPs, but the end result is separate reports from each. This almost inevitably means that there are loose ends between the two. Providing suitable safeguards can be put in place to ensure the independence of PJ's opinions, a fully integrated, combined report, would reduce the possibility of risks “slipping between the cracks”.
- RM has built up a strong team to manage the project finance portfolio, which now includes all “structured loan” PPPs. After financial close, major changes, e.g. restructurings, are proposed by RM and reviewed by Ops before being submitted to the Management Committee for approval. Intermediate decisions are approved at the Director General level of the two directorates. Lower level decisions, e.g. as to waivers, are approved within RM. Formal annual credit reviews take second place to other portfolio management work, even where the Bank is on-risk, and there is only limited formal credit reporting on loans where the Bank is not yet taking project risk, especially during construction. However, since 2003, formal credit reviews have been systematically prepared by RM for all projects where the Bank is exposed to risk.
- The extent of JU involvement in PPP loans is largely a resource issue. In cases where there are commercial bank lenders or guarantors, the Bank may make use of the work done by their external lawyers, but may also take separate advice to review inter-creditor documentation, or to review project documentation, where it feels that the commercial banks' lawyers are not appropriate for this purpose.
- The EIB's filing systems are not well adapted to project finance-type loans. These generate large volumes of filing, and there is no clear policy on long-term retention. Similarly, the Bank's main IT tools were not designed to cope with the two-stage appraisal and approval process used in BAFO-based PPP procurement. However, this issue was being addressed.

## 6. RATING AGAINST EVALUATION CRITERIA

The following table summarises the individual and overall ratings projects which were evaluated in-depth:

Criterion	Project Rating			
	Good	Satisfactory	Unsatisfactory	Poor
Relevance/Efficacy	4	6	-	-
Efficiency*	2	4	2	-
Sustainability*	2	5	1	-
<b>Overall Rating</b>	<b>4</b>	<b>4</b>	-	-

\* Two projects could not be rated for Efficiency or Sustainability and were therefore also not given an overall rating.

### 6.1 *Relevance/Efficacy*

#### Relevance

**EU Policies** - All projects' objectives are consistent with at least one EU policy, e.g. Transport, TENs, Regional Development Environment, and most support more than one. All projects rate well against Relevance, or will do once fully operational.

**EIB Policies** - All projects were eligible for EIB funding, and six are also consistent with the priority policy objectives of Regional Development, Environment and Education.

#### Efficacy

All project were rated as either "Good" or "Satisfactory" overall, although the rating for one project should be regarded as provisional until the project is fully complete. However, any problems on that project appear so far to be largely attributable to interface problems with a related, public-sector procurement project. One project was strong on Relevance but weak on Efficacy; the project is over-budget and late. The problem has not been with the Provider; it has been the inability of the public-sector Promoter to define its needs and to manage multiple, interlocking PPPs. Once complete, and assuming the full benefits are being achieved, the Satisfactory rating would almost certainly apply to both Relevance and Efficacy.

### 6.2 *Efficiency*

Two projects could not be rated because they had only just been completed at the time of the evaluation. Depending on future traffic development these might reasonably be expected to be rated as "Satisfactory" at some point in the future, although initial traffic levels on a part-completed motorway were below forecast. Another two projects were rated as less than satisfactory: one suffers from low traffic levels, and the other has suffered cost overruns which are reducing the economic benefit.

Traffic levels have been lower than expected on a further two projects, both roads, but not to the extent that the economic viability of the projects has been compromised. In the first case, the problem is a combination of wider economic problems reducing traffic levels and a delay in completing a linked section of motorway. For the second, a combination of lower than expected traffic growth due to regional economic problems, and exogenous factors, has resulted in traffic which is lower than the Provider's projections – but not the Promoter's.

### 6.3 *Sustainability*

All except one project have been rated as Good or Satisfactory, and all projects are expected to be physically sustainable, with the Providers having sound incentives to maintain them properly. The project rated Unsatisfactory has a potential financial weakness, but should still meet its original economic objectives.

#### Financial

The projects at most risk are those where the Provider is carrying the market (usage). Of these, one is being managed by a financially strong group which can accept low initial returns in the expectation of a full recovery in the long term. The position of a motorways project which was not rated because of the early stage of its development, is currently only Sustainable by virtue of the EIB lending being based not just on a bullet repayment of capital, but also the 100% capitalisation of interest. Current projections, as accepted by PJ, show that there will be enough free cash flow to repay the commercial banks, but not to build up sufficient funds to repay the Bank's bullet loan. This suggests that some degree of refinancing will be required in the future. However, the Concession stretches well beyond the term of the EIB loan and the Bank expects that there will be sufficient revenue, after the initial commercial bank loans have been paid off, to interest commercial banks in such a refinancing. This potential refinancing structure was foreseen at appraisal and is reflected in the design of the Bank's operation. The Provider on the third project is under financial pressure. The effect has been to reduce projected equity returns to zero for at least a decade, unless a financial restructuring takes place.

#### Technical

Technically, all projects are sound and sustainable, with no particular problems identified during the evaluation.

### 6.4 *Complementary Criterion - Institutional Development*

As will be shown in §8, there are many cases where the Bank provided significant non-financial value-added, generally to the public sector rather than the private sector, but it is not clear how much of this represented Institutional Development. However, the exposure to the Bank's skills, and the opportunity to learn from the Bank's experience, was seen by almost all Promoters as a valuable aspect of having the Bank involved in their projects.

Institutional Development was neither an EIB policy nor an EIB objective for these projects, but it was clear that some degree of development had been achieved on most projects, particularly those in countries at an early stage of PPP development. It was also clear that EIB staff, formally and informally, were making significant contributions to PPP skills in at least two countries.

## 7. EIB PERFORMANCE

### 7.1 *Pre-Appraisal*

The Bank has no formal system for tracking the project selection process. This makes it difficult to confirm the degree of selectivity. It would therefore be useful if the Preliminary Information Note (PIN), the successor to the *Relevé Quotidien* (RQ), were to summarise the history of the Bank's involvement to date. The people involved in projects had often forgotten how the EIB had originally got involved, or had inconsistent recollections. Synthesising the various comments suggested that there were three main routes:

- Through existing contacts with, e.g. central government, and the selection of the most appropriate projects from a portfolio of available projects. It is not the Bank's role to promote or develop projects in isolation or on behalf of third parties, and this approach allows the Bank to select projects which are the most appropriate fit with its Corporate Operational Plan.
- Through an approach from the Promoter at some stage during the procurement process; this commonly led to the Bank providing financing proposals to the final bidders to be incorporated into their bids (*cf.* §5.2)

- Through an approach from the winning bidder (Provider)

The second and third approaches suggest that lending was reactive to requests, rather than proactive in seeking to maximise policy impact. However, the Bank was selective and did not accept all projects offered. The Bank has little to contribute at the project definition stage, particularly when it is dealing with competent Promoters. On the other hand, suggestions were made to change the structure of a motorway project which would have increased its viability - but the Promoter did not accept them.

The projects' eligibility for Bank finance was normally based on either or both of section (a) or section (c) of Art. 267 (formerly Art. 198) of the Treaty of Rome, *i.e.* that the project was in a Objective 1 or 2 development area, and/or that it related to a Trans-European Network (TENs) route (in the case of roads), or produced specific environmental benefits.

In a number of the projects evaluated in-depth, the project boundaries were larger than the PPP Contract. In the case of an urban motorway, land acquisition and ancillary works being undertaken by the state were included as part of the overall project, while on a second motorway, loans to the Promoter for one section of the road, and to the Provider for another, were initially dealt with as one application, although actually appraised separately by PJ. For a rail project, the costs of additional works undertaken by the state were correctly included when calculating the EIRR and excluded when calculating the limit on the EIB's contribution to the contract.

## **7.2 Project Appraisal**

Procurement procedures were always in line with EU and EIB policies. In one case, the process was not entirely satisfactory in terms of the results achieved, but accepted by PJ as being in line with the Bank's Procurement Procedures. The Bank's standard environmental assessment procedures were carried out on all projects. Projects located within the EU at the time of appraisal also received a favourable opinion from the European Commission (EC) on compliance with EU legislation. Only two projects raised any environmental concerns. On the public-sector financed part of an inter-city motorway past a major conurbation, between the sections built by the Provider, there was an issue relating to the effect on the local water supply. This section had already been financed by the Bank, which was criticised by a non-governmental organisation for doing so. On a rail project, the EIB's loan originally received a negative opinion from EC on environmental grounds. This surprised both the Bank and the Promoter but the issue, relating to the habitat of an indigenous mouse, was relatively minor and was dealt with by a further study.

While the background of the Provider's shareholders was always reviewed, though sometimes in limited detail, very little attention seems to have been paid to the quality of the Provider's Operational Management, or how it was to be organised and run. This might appear reasonable, given the strong links between the Providers and the Contractors, all of whom were experienced and capable of carrying out or overseeing the construction work. However, as SPVs with responsibility for O&M stretching into decades, a deeper analysis of the Provider's operational expertise and stability might have been expected.

The calculation of the Project Cost for some projects was complicated by elements which were part of the overall project, but not part of the PPP, and elements of the PPP which were not eligible for EIB funding. This led to some ineligible costs filtering through to the Bank's Project Cost definition, e.g. IDC on ineligible components, operating costs during implementation, maintenance reserve accounts, and general working capital. The overall impact of these costs was small, but indicative of the problems associated with abnormal projects.

### Economic Profitability

PJ calculated an *ex-ante* economic internal rate of return (EIRR) in constant terms for all except one of the projects evaluated. On an education project, PJ relied on studies showing that general investment in education has a positive impact, but that no meaningful ERR can be calculated for activities such as compulsory education. This approach means that it is difficult to know whether the proposed investment offers an acceptable economic return. The calculated EIRR for the other projects was generally in the range 9-14%, although the calculated figure for a rail project was only 4%. This was seen as marginal, but acceptable in the light of substantial, unquantified domestic benefits, e.g. from economic regeneration.

### Financial Profitability

On most projects, the value to the Bank of a Financial Internal Rate of Return (FIRR) calculation is doubtful and is no longer a compulsory part of EIB project appraisals. However, on PPPs, particularly those where the Bank is on-risk during the operational phase, the financial viability of the project is an important element in the overall risk analysis : measured primarily by the equity IRR, rather than the FIRR. The highest FIRRs were found in two toll motorways, which reflects the high real domestic interest rates at the time of construction. Otherwise the higher (*ca.* 10%) FIRRs were generally found in new PPP markets.

### Risk Analysis

A steady improvement in the approach to project risk evaluation by EIB can be seen in the later projects examined, although there seems to be no standard format for this, and it suffers from a split of responsibilities between OPS and PJ. Particular attention was paid to the risks relating to revenues, with a range of scenarios being tested for all projects. However, although projections were usually based on more conservative scenarios than those of the Promoter or Provider, they were sometimes still not conservative enough. On a rail project, which has a combination of high levels of guaranteed availability and heavy penalties for non-performance, there was a particularly detailed analysis of the availability. There was a similarly detailed risk and mitigant analysis by OPS covering both general risks, e.g. performance and payment regimes, and termination, and specific risks such as derailment.

The Bank's approach to credit risk is conservative and quite stringent, reflecting its statute, and is now codified in a set of credit risk guidelines. Where the Bank will be on-risk at some point in the project, a set of guarantee-release criteria are established and approved *ex-ante*. These are based on a minimum loan-life cover ratio, a minimum project contractual life cover ratio, a minimum annual debt service cover ratio; and a minimum period of operations with an economic performance in line with the base-case projections. Although the guidelines had not been formally put in place at the time the in-depth projects were approved, the same principles had been applied. None of the projects examined show any signs of imprudent lending by the Bank. Indeed it could be argued in some cases that the Bank's financial value-added would have been more substantial if it had been prepared to take the same post-completion project risk as it has on other projects.

### **7.3 Loan and Guarantee**

The EIB's loan is often *pari passu* with a loan provided by commercial banks, but the Bank is usually by far the largest single lender, since commercial banks normally syndicate out their exposures. The Bank's policy is not to finance more than 50% of eligible project cost and the evaluation found that this limit was respected. However, the Bank was regularly providing very high proportions of senior debt: up to 100%.

The Bank's statute states that the interest rate on its loans “.....shall be calculated in such a way that the income there from (*sic*) shall enable the Bank to meet its obligations, to cover its expenses and to build up a reserve fund.....”<sup>5</sup>. With this rate-setting approach, and the Bank's AAA rating, the Bank's lending rates should therefore be lower than those of commercial banks.. “Risk Pricing” for EIB loans was introduced in 1999 to reflect the extra risk of loss in cases where normal risk-mitigation and externalisation measures are not achievable due, in particular, to market constraints. Some characteristics of the funds requested by the Borrowers noted in the evaluation were :

- Floating-rate (Euribor or LIBOR) EIB funding was swapped by intermediary banks into fixed-rate funding, although the Bank could have provided fixed-rate funding itself. This may be partly because the Bank requires a higher level of guarantee cover for fixed-rate operations, to take into account the higher breakage costs associated with early repayment.
- The use of intermediary currencies instead of funding in the desired currency. In one case, a loan in USD was swapped into EUR. By providing USD it was possible to create a greater financial benefit than had the local currency been used. Despite swap costs

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<sup>5</sup> Article 19, EIB Statute

incurred, the benefit to the project was still greater than had the loan been denominated in local currency.

It is normal for most of the debt interest costs on a PPP project to be either hedged or fixed throughout the life of the loan. This was not the case for a road infrastructure project, a risk which was not recognised in the financial appraisal of the project. Similarly, an urban motorway was at risk from exchange-rate movements between its debt (in ECU and other pre-Euro currencies), and local currency-based revenues, but again the point was not analysed at appraisal.

It was noted that the Bank is prepared to modify the standard reimbursement structure of its loans to suit the needs of the project. Typically this involves accepting lower levels of repayment in the early years, to ease the project's cash-flow, with acceleration after commercial bank loans have been repaid. In one extreme case, the loan is a bullet loan with capitalisation of all interest payments to ensure the financial sustainability of the project. A side effect of this approach was its impact on the Bank's exposure vis-à-vis the Bank's limit on the proportion of project cost it will finance. While the Bank's initial loan of EUR 275 million was well below the 50% maximum, the Bank's exposure to the project reaches some EUR 797 million, against project costs, including IDC, of EUR 871million.

#### Security Structure, Refinancing and Guarantee release

The typical EIB PPP loan structure, used in most of the projects examined, is for the EIB to provide a long-term loan to the Provider. This is 100% bank-guaranteed, at least until after completion of works and early operation of the project. The guarantee may then be partly or wholly released in stages, provided the project is achieving its preset targets. After this point, the Bank is taking full project risk.

However, on a road infrastructure project, the EIB's long-term loan is backed by shorter-term guarantees from commercial banks. The terms of the guarantees reflected the unwillingness of commercial banks to take a longer risk on the projects, and these terms were reflected in their own direct loans. If the guarantees are not renewed, the EIB loan is defaulted and must be repaid, but the projects would not be able to do this without other financing being available. If financing is not available, then there would be a call on the guarantee, and the risk would be transferred to the guarantor. Assuming the loans will be renewed, the project's interest-rate risks have not been hedged for the extension period.

Several Providers said that while EIB funding was good for their projects, it also created extra risk for their investors. The Bank tends to set guarantee release conditions which are more stringent than those which would be accepted by commercial banks. While this approach is prudent, it could lead to the Bank refusing to release guarantees on a project which was performing satisfactorily in all respects except one critical ratio. The impact of a guarantee release being refused could be significant for both the Provider's investors and the Promoter, depending on the structure of the contracts.

#### **7.4 Project Implementation**

Disbursement of loans to PPP projects should only take place when there is evidence of expenditure by the Provider, with appropriate certification of this expenditure from the TA. When the EIB's loan is made in parallel with, or guaranteed by, a commercial bank syndicate, such controls are automatic under inter-creditor arrangements. However, in some of the projects reviewed where the EIB was not in this situation, these controls did not appear to be fully in place. There was a case where the EIB's loan has a state guarantee, the whole EUR 275 million of the initial EIB loan was disbursed into an offshore escrow account, with payments from this account controlled by the Promoter, the agent bank for the other lenders, and the EIB's guarantor. In other cases, "lump-sum" disbursements were used to match the EIB's funding arrangements. This begs the question of whether funding arrangements should drive the disbursement process.

#### **7.5 Project Monitoring Post Completion**

PJ is monitoring the post completion phase of only one out of the ten projects evaluated in-depth. Even where the Bank is on-risk, and a higher degree of physical monitoring might be indicated, it is RM which carries this out, supported where necessary by OPS. For non-financial matters, RM relies on the independent advice provided by the TA appointed on behalf of the senior lenders.

Completion monitoring was very limited, with a bare minimum of information being included in many of the Project Completion Reports (PCRs) prepared by PJ.

## **8. EIB VALUE-ADDED**

There is only one case where the project could not have proceeded without the EIB's participation, or at least not without being substantially revised. Conversely, there was also at least one case where the project would have proceeded with exactly the same funding structure whether the Bank had got involved or not. In between these two positions, the Bank usually had an impact on the affordability of the project, e.g. in one case, the Bank's presence had a significant impact on how the overall project was structured between the public and private sector.

While issues of loan term and repayment profile were important, the most important reason for the EIB being brought into the projects was its lower “all-in” cost of financing. This raises the issue of displacement of commercial lending, especially as this lower cost did not always accrue to the public sector. However, once the EIB was involved, other types of value-added from the Bank's presence could also be identified. This was particularly true in new PPP markets. In most cases it was the fact that the EIB offered a much longer loan maturity than other financing sources, often combined with fixed-rate pricing, which made the difference, although absolute availability of alternative funding, *i.e.* the ability and willingness of domestic or international banks to fund the project, was probably also a factor in two, or possible three countries.

### **8.1 Financial**

There are cases where the final project scope depends on costs, *i.e.* the cheaper the funding, the greater the scope of the project. An education project evaluated in-depth is a good example where lower-cost EIB funding clearly provided some financial additionality. This effect made a difference to the affordability of some projects and to the scope of others. In some cases, EIB involvement may also have helped to keep down the parallel commercial lenders' pricing and so produced a further, indirect reduction in costs.

#### EIB role in financing

Most of the projects under evaluation could have been financed in full by commercial funders, albeit at higher cost. However, EIB involvement in a project does not normally create conflict with commercial funders:

- They still get business from guaranteeing the EIB's loan until after completion of construction, and sometimes throughout the life of the loan;
- EIB's assumption of risk on guarantee release, or refinancing, cuts down the average life of commercial banks' commitments, which is desirable from their point of view. Commercial banks normally prefer not to be long-term lenders;
- Commercial bank involvement would probably be based on a syndication anyway;
- The commercial banks get ancillary business, such as the interest rate swaps;
- There is a validation effect in the EIB's presence.

None of the commercial banks contacted during the Evaluation raised any objection to the EIB's presence, and some of them particularly drew attention to the benefit of the Bank's validation of projects, contribution to negotiations (*cf.* 5.4), and thereafter during the on-going monitoring of the operation.

Several Member States are now beginning to use public sector funding for PPP projects, in effect adding to what the EIB is already doing in this field, *e.g.* the U.K. Treasury's “Credit Guarantee Finance”. These are public-sector loans to PPPs, guaranteed by commercial banks or insurance companies, and are an obvious parallel with the EIB's role. Similarly, there is the provision of funding for PPPs by Infrastrutture SpA in Italy. This approach lowers total costs and is something that Providers have also been looking for in other countries, *e.g.* Germany.

Competitive tension amongst bidders should ensure that the EIB's cost benefit is fed through to the Promoter's end-cost, provided EIB funding terms are made available to bidders before they submit their final offers. This appears to have been the case in the majority of the projects



evaluated, although, as discussed in §5.2, there may be a case for a higher level of EIB credit approval at the final bid stage of procurement to ensure that bidders make best use of EIB funding and fully reflect its terms. In the projects evaluated where the Bank came into after the appointment of the preferred bidder, it was clear that the benefit from lower EIB funding costs was retained by the Provider and/or intermediary bank.

#### Catalytic Effect / Market Development

There were only a few cases amongst the projects evaluated where the EIB truly acted as a catalyst to develop third party funding for PPP projects. However one case, an inter-city motorway in a less developed region, illustrated the potential value of EIB assuming this role in new markets, with the Bank actively encouraging participation by local and foreign banks, and promoting longer-term financing through its guarantee release structure. This was on the personal initiative of a member of staff, rather than an EIB policy, but there were similar possibilities on other projects. The Bank might have increased its value-added if it had taken advantage of these opportunities.

#### Risk Assumption

There is a direct link between the Bank accepting project risk and the cost of its funding. If the Bank does not take project risk, the Provider/Borrower normally has to pay the extra cost of commercial bank guarantees. It is clear from discussions with OPS and RM that the approach to risk assumption tends to be *ad hoc*, rather than based on a specifically evolved policy or experience. While operations are always within the framework of the Bank's Credit Risk Guidelines, the decision to accept risk is influenced by whether the EIB pricing would remain competitive once the cost of guarantees is included.

#### Swaps

This is an issue which primarily affected the UK PPP projects evaluated in-depth. There is a danger that a significant proportion of the EIB's funding cost advantage could be absorbed by the margins charged by swap banks, where the swap process is managed by the Provider, but it is the Promoter which carries the cost. In OPS' opinion, the outcome of the swap is not something which should concern the Bank. However, given that the Bank already has sophisticated treasury expertise, there is scope for the EIB to increase its value-added by working with the Promoter and its financial advisers during the swap process. PPP Promoters often have very limited experience in this field and may have to rely on inadequate advice. Swap guidance was provided by Ops on a toll motorway project, using FI expertise. The currency swap pricing was checked to ensure it was competitive, despite the fact that the Promoter was only taking the risk of changes in government bond rates between BAFO and financial close, rather than swap market or exchange rates.

#### Developing Financial Value-Added

The Bank's scope for increasing its financial value-added is limited, e.g. operating efficiency gains and the development of products to meet particular needs. There might be more opportunities in the area of risk management and structured funding, with the Bank accepting more risk on more projects, while continuing to act within its credit risk guidelines.

### **8.2 Non-Financial Value-Added**

The Promoters, Providers and commercial banks involved in the evaluation identified a number of areas where they felt that the Bank had brought substantial, non-financial value-added to their projects:

#### Project Validation

Promoters generally found the Bank's techno-economic and financial appraisals helpful in validating both their decision to go down the PPP route, and the structure selected for the project. Similarly, other lenders to the projects had a high opinion of the EIB's project appraisal process, especially in the economic and engineering fields. In some cases this made it easier for commercial bankers to get their own internal credit approvals and was especially helpful where the commercial bank loan underwriters were placing their loans in the syndication market. The effect was most obvious where the loan was the first of its type in the market.

### Post-Signature Partnership

The EIB is generally considered to be a “good partner” by the commercial banks; one which plays a major role in the funding and which acts in a responsible and consistent manner. The alternative would be a much larger syndicate with less predictable partners from whom approval would be needed for all variations, waivers, etc.

### Skills Transfer

Transfer of PPP experience from one country to another is another important contribution which the EIB can make to the process and which was remarked on by several Promoters and Providers in new PPP markets.

### Long-term commitment

Several Providers commented that they are more comfortable with the EIB’s policy of holding the whole of its loan for its entire life, thus creating a long-term partnership with their lender, than the approach of commercial banks who trade-in their loans on the secondary market.

### Political effects

EIB’s status as a multilateral bank owned by the EU member States produces several political effects:

- A number of Providers and commercial banks commented that they felt that the EIB's presence in a project would help to ensure that the Promoter or its government would meet its contractual obligations.
- Several Promoters also said that the involvement of “European money” *via* the EIB made their project more acceptable, in regions where there was opposition to the use of PPPs on political grounds.

### Developing Non-Financial Value-added

The Bank's non-financial value-added can have a substantial impact on the development of PPPs at both the national and individual project levels. The development and negotiation of PPP projects in a new market requires skills which are often not available to the Promoter. PPP Task Forces within key ministries can provide valuable support to Promoters. However, this support can only be offered once the task force has been able to build up its own experience and early-stage assistance will be limited. Similarly, unless private-sector staff are seconded-in, a PPP Task Force may lack private-sector skills and experience. To a certain extent, this gap can be filled by employing outside advisers, *e.g.* on financial and legal matters, but most of the Promoters said that they would welcome a more significant role for the EIB as a mentor providing institutional support in the development of their PPP policies and individual projects. This does not mean displacing private sector financial advisers, but there are areas in which the Bank might offer valuable advice, including: creating a PPP Taskforce, PPP framework legislation and standard terms/documentation, procurement procedures and bid evaluation, PSC and VfM, etc. The Bank could also provide support to Promoters in their relationships with financial and legal advisers. The EIB is already providing this kind of institutional support on an *ad hoc* basis but a more formal arrangement could have a greater impact, and be self-financing.

**EIB PPP PORTFOLIO**

The following figures for amounts disbursed are based on the PPP definition used for this evaluation and were correct as of the start of the evaluation.

<b><u>EIB Loans for PPP Projects to Date from 1990 To 2003</u></b>		
<b>Sector</b>	<b>Contract amount</b>	<b>% of total</b>
	(€m)	
Roads and motorway (includes combined road/rail projects, tunnels and bridges)	9,120	62%
Urban development, renovation and transport	2,600	17%
Airports	999	7%
Traditional and high-speed trains	997	7%
Social infrastructure (education and health)	549	4%
Power generation, transmission, and distribution	258	2%
Drinking and waste water treatment	165	1%
	<b>14,688</b>	<b>100%</b>

## EUROPEAN INVESTMENT BANK OPERATIONS EVALUATION (EV)

### EVALUATION CRITERIA

Project performance is assessed using the core evaluation criteria as defined by the Evaluation Cooperation Group (ECG), which brings together the operations evaluation units of the multilateral development banks (World Bank group, regional development banks, and EIB), in line with the work of the OECD- DAC Working Party on Aid Evaluation, and adapted to meet the particular operating needs of the EIB. Evaluations take due account of the analytical criteria used in the ex-ante project appraisal and the strategy, policies and procedures that relate to the operations evaluated. Changes in EIB policies or procedures following project appraisal, which are relevant to the assessment of the project, will also be taken into account.

- Relevance is the extent to which the objectives of a project are consistent with the relevant EU policies (the Treaty, Directives, Council Decisions, Mandates, etc.) and the decisions of the EIB Governors, as well as the beneficiaries' requirements, country needs, global priorities and partners' policies. In the EU, reference is made to the relevant EU policies in the context of the Article 267 of the Treaty that defines the mission of the Bank and the EIB related policies. Outside the Union, the main reference are the Community's relevant external policy objectives considered in the specific mandates given to the EIB by the Council of the European Union and the EIB interpretation of them.
- Efficacy (or effectiveness) relates to the extent to which the objectives of the project have been achieved, or are expected to be achieved, taking into account their relative importance, while recognizing any change introduced in the project since loan approval.
- Efficiency is the measure to which project benefits/outputs are commensurate with resources/inputs. For the ex-ante appraisal, a project's efficiency is normally measured through the economic and financial rate of returns. In public sector projects the economic and financial rate of returns often are not calculated ex-ante. In those cases the efficiency of the project is estimated by a cost effectiveness analysis.
- Sustainability relates to the likelihood of continued long-term benefits and the resilience to risk over the intended useful project life. The assessment of the project's sustainability varies substantially from one case to another depending on circumstances and takes into account the issues identified in the ex-ante due-diligence carried out by the Bank. Among the issues reviewed in the assessment are:
  - Technical and management issues, mainly willingness, capacity and funding to carry out the necessary maintenance of the project in order that it can reach its useful life;
  - Government commitment, regulatory environment and socio-political support (this is particularly important in weak institutional context such as in some developing countries);
  - Financial sustainability for revenue generating projects, whether there is a significant risk that those revenues become unacceptably low, e.g. that they cannot cover at least the operating and maintenance costs;
  - Environmental sustainability, whether there are environmental risks that might be a significant threat to the future operation of the project.
  - Others issues that might affect the continued long-term benefits during the useful project life.

## **EUROPEAN INVESTMENT BANK OPERATIONS EVALUATION (EV)**

In 1995, Operations Evaluation (EV) was established with the aim of undertaking ex-post evaluations both inside and outside the Union. Self-evaluation was introduced in 1999.

Within EV, evaluation is carried out according to established international practice, and takes account of the generally accepted criteria of relevance, efficacy, efficiency and sustainability. EV makes recommendations based on its findings from self-evaluation and ex-post evaluation. The lessons learned should improve operational performance, accountability and transparency.

Self-evaluation, based on a project scorecard system, is carried out by the operational directorates. EV coordinates this process, and prepares an independent annual self-evaluation report.

Each ex-post evaluation involves an in-depth evaluation of selected investments following which a synthesis report is produced and sent to the Management Committee. The Management Committee then decides if the report is to go to the Board and be published on the EIB Website, in keeping with the importance the Bank attaches to transparency.

The following thematic ex-post evaluations have been published on the EIB Website :

1. Performance of a Sample of Nine Sewage Treatment Plants in European Union Member Countries (1996 - available in English, French and German)
2. Evaluation of 10 Operations in the Telecommunications Sector in EU Member States (1998 - available in English, French and German)
3. Contribution of Large Rail and Road Infrastructure to Regional Development (1998 - available in English, French and German)
4. Evaluation of Industrial Projects Financed by the European Investment Bank under the Objective of Regional Development (1998 - available in English, French and German)
5. An Evaluation Study of 17 Water Projects located around the Mediterranean (1999 - available in English, French, German, Italian and Spanish).
6. The impact of EIB Borrowing Operations on the Integration of New Capital Markets. (1999 – available in English, French and German).
7. EIB Contribution to Regional Development A synthesis report on the regional development impact of EIB funding on 17 projects in Portugal and Italy (2001 – available in English (original version), French, German, Italian and Portuguese (translations from the original version)).
8. Evaluation of the risk capital operations carried out by the EIB in four ACP countries 1989-1999 (2001 - available in English (original version), French and German (translations from the original version)).
9. EIB financing of energy projects in the European Union and Central and Eastern Europe (2001- available in English (original version), French and German (translations from the original version))
10. Review of the Current Portfolio Approach for SME Global Loans (2002 – available in English (original version), French and German (translations from the original version)).
11. EIB Financing of Solid Waste Management Projects (2002 – available in English (original version), French and German (translations from the original version)).
12. Evaluation of the impact of EIB financing on Regional Development in Greece (2003 – available in English (original version) and French (translation from the original version)).

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13. Evaluation of Transport Projects in Central and Eastern Europe (2003 – available in English (original version).
14. EIB Financing of Urban Development Projects in the EU (2003 – available in English (original version), French and German (translations from the original version)).
15. Evaluation of the Projects Financed by the EIB under the Asia and Latin America Mandates (2004 – available in English (original version), French, German and Spanish).
16. Evaluation of EIB Financing of Airlines (2004 – available in English (original version) French and German)
17. Evaluation of EIB Financing of Air Infrastructure (2005 - available in English (original version)).
18. EIB financing with own resources through global loans under Mediterranean mandates (2005 - available in English (original version) and French).
19. Evaluation of PPP projects financed by the EIB (2005 - available in English (original version).

These reports are available from:EIB website: <http://www.eib.org/publications/eval/>.  
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