EvD Special Study: Private Sector Participation in Municipal and Environmental Infrastructure Projects—Review and Evaluation Management Comments

1. Summary

Management recognises the importance of private sector participation (PSP) in municipal and environmental infrastructure and service sector (MEI) and welcomes the review and analysis of the study. The report provides a review and assessment, including through case studies, of the Bank's objectives and activities supporting PSP in MEI between 2001 and 2012. Overall the report paints a complex picture providing both some criticism but also acknowledgement of achievements and indeed difficulties encountered in pursuing a PSP line of operations. The study recommendations range from those related to the diagnostic analysis of the challenges/gaps and past experience in PSP in the projects documents; project design and structure; the Bank's approach in developing standards, expertise and policy dialogue in the area of public private partnerships (PPPs); and, on reporting on the implementation of PSP-supporting activities. The report is timely, given the evolving nature of PSP, and its findings provide the Bank with the opportunity to reflect on ways to enhance its activities in this area.

Management has already provided extensive informal comments to the draft of the EvD study on PSP in MEI operations.. The focus of these comments is on main findings and the recommendations of the study from the viewpoint of their value for learning.

2. Main Findings

- Management welcomes the analysis in the study and its recognition of the difficulties involved in promoting a uniform PSP strategy/approach for the sector. Indeed, PSP can and is accomplished in many different ways, many of which are not the classic, long-term PPPs that were common 10 years ago. Management believes that in order to improve its usefulness as a learning tool with lessons for the future, the study could provide a better assessment of the causal process that has led to a perceived decline in PSP activities. More specifically, the study conflates potentially internal causes within the EBRD with external causes that are outside the control of the Bank (such as the general global trend of decline in PPPs or, closer to home, the availability of EU grants and their effect on the PPP market). If this analysis is taken a step further it could allow for a clearer set of lessons that could set up a realistic and ambitious objective in the PSP area for the Bank going forward.

- The study argues that PSP appears to have declined as a strategic priority in MEI's strategies over the past 15 years. Management notes that PSP remains core to MEI's strategy whereas the current approach reflects greater realism on what can be achieved in today's market given the numerous constraints identified in the study, including limited institutional capacity to accommodate PSPs and the readiness of the market to invest, as well as the evolving nature of PSP. As the study recognizes, PSP activity has declined in the current economic market. While Management agrees that the country strategies analysed in the report do appear to place a greater emphasis on the opportunities for PSP in the municipal sector than MEI does in its own strategy, this may merely be reflective of the sample of countries chosen (Croatia, Poland, Russia and Turkey), where market conditions are better than in other countries. If the

sample includes all countries of operations, Management anticipates that the emphasis placed on PSP would be more in line with MEI's strategy.

- Management notes that the reported amount of TC funds to support PSP might understate the actual TC money spent to support PSP as these tasks are sometimes included in a broader context, being either funded by loan proceeds or by non-Bank TC sources. For instance, the EU funded a very large study for private water concessions in three Romanian cities (approx. EUR 1 million). In this regard, it is also important to point out that the amounts needed for PSP preparation are typically over EUR 1 million, in line with the complexity of projects, and such amounts are not always readily available from donor funds.

3. Study recommendations

- Management believes that the project document changes implied by the first recommendation are not always justified. The first recommendation requires that management includes a discussion on PSP status and market gaps in all new MEI board documents for public sector projects, including Bank efforts to introduce PSP with both the project client and other clients. The recommendation implies that PSP should be generally recognised as the ultimate solution for the delivery of public services under any condition. Management notes that this assumption is not always appropriate from a policy standpoint and may also involve reputational risk for the Bank (i.e., mandating PSP if the market or legal framework is not ready). In addition, in many markets the role of the private sector in the delivery of public services is in debate with no consensus emerging across the Bank's countries of operations. A discussion on PSP status and market gaps in MEI board documents for public sector projects should therefore be included only when appropriate (e.g. PSP realistically features in the project or in the (rare) cases covered in recommendation 2 where there is displacement).

- Management disagrees with the third recommendation of the study proposing to covenant PSP in the loan agreements. The approach has been tried unsuccessfully in the past as city or regional councils will not approve legal documents where they are giving 'legally binding commitment' to PSP while PSP has not yet been structured and value-for-money robustly established. Prior to embarking on PSP, a local authority will require detailed feasibility studies to prepare the project as well as to assess market appetite. Indeed in some projects, the findings may be that PSP is premature or that market appetite is limited. Therefore, Management will consider covenanting on a case by case basis as appropriate. As the Bank's clients become more knowledgeable about PSPs, they are reluctant to take legal risks or incur the administrative costs by agreeing to covenant PSP. Moreover, PSP options can change following the initial feasibility analysis. In Sibiu Urban Transport, for example, the consultants determined that the bus company was too small for a full scale concession. Given the different forms that PSP can take and the time and costs involved in preparation, Management believes that a more operational approach could be to covenant, in appropriate cases, the commitment to undertake a PSP feasibility study, including model tender documents. Whether the PSP actually goes forward is partly dependent on factors outside the control of the local authority (e.g. the private sector having appetite to bid, financing being available, etc.).

- A number of the proposed recommendations and measures related to the Bank's approach in developing standards, expertise and policy dialogue in the area of PPPs (recommendations 5-8) are already being considered or indeed some are implemented as part of the joint Banking –OCE Infrastructure Policy Dialogue Plan (IPDP) for 2014-2016. As part of this plan, MEI is recruiting a policy dialogue expert who will focus on PSP. Recruitment is well underway. While this expert will provide leadership, the team will also continue to build PSP capacity throughout MEI staff so as to not to concentrate this activity in one individual. Also, PPP monitoring units are planned to be TC funded (e.g. Turkish hospital PPPs). Various policy dialogue aspects developed over the past years have focused on PPPs and how to improve their delivery. In addition to LTT's work on legal frameworks, MEI is supporting PPP structuring and institutional strengthening in diverse areas, such as Romania's smart card ticketing; Serbia, Croatia and Albania's parking; Kazakhstan urban rail and PSP models for solid waste management in Russia and Central Asia in particular. The Bank has started to explore providing on systematic basis longer term assistance to build up monitoring and regulatory capacity in the initial years of PPPs operations, in order to minimise conflicts and to ensure better outcomes.

- Management agrees that opportunities to explore PSP could be given some more attention, particularly in urban transport where and when private operations are feasible. Nevertheless, the fourth recommendation that "*financing for bus fleet renewals of public transport companies should ordinarily require explicit commitment by municipal authorities to allow or expand PSP in the sector*" should be qualified. Indeed, what is needed is a balance between private and public sector operators, not a 100 per cent private sector approach, and always subject to robust quality and service standards, which the private sector has not always upheld in a consistent way.

- In relation to recommendations 9 and 11, Management notes that the methodology for the Assessment of Transition Challenges in the municipal subsectors (water & waste water and urban transport) encompasses PSP as one of the dimensions assessed (recommendation 9). Expanding this aspect to a stand-alone analysis of PSP should only be considered against the associated increased costs related to the staff-time required for the analysis and indeed if it can trigger better operational responses.

- Management believes that annual reporting on PSP activities (recommendation 10) should be presented as part of policy dialogue reporting (e.g. IPPF) to reduce transaction costs and avoid the unnecessary multiplication of such reports. Alternatively a report (e.g. another EvD study) could be presented every 3-5 years to make the work manageable and accumulate slightly more results to report on. Also, the new 5 years sector strategy period will guarantee that such an update is made regularly.

4. Other comments on the study

- Management stresses that developing the regulatory framework such as tariff reform is important for PSP operations. The study focuses on the developments based only on the number and volume of completed PSP operations in the MEI sector and comments on page 29 that transition objectives related to Framework for Markets (RAB tariff methodology) is unusual for a private sector operation (Rosvodokanal). It is important

to note that this is one of the avenues that may in the long term improve the overall prospects of PPPs in the water sector in Russia and the region more widely, as it introduces a mechanism that makes investments in the water sector commercially viable and attractive for the private sector.

- Management notes that the methodology for assessing transition impact used by EvD is not consistent with that used by the Office of the Chief Economist (OCE) in the Transition Impact Monitoring System (TIMS). For instance, during project evaluation, EvD considers all of the seven potential sources of transition impact and not only the key transition objectives identified ex-ante by OCE and as presented to the Board at project approval. In addition, EvD rates the "realised" transition impact at the time of project evaluation, which may precede project completion/repayment, while OCE's transition impact in TIMS is measured as an expected value, i.e. the product of the transition impact potential and risks. The differences between the two methodologies are larger for projects that are under implementation and for which risks to transition impact are still significant. This may explain the discrepancy between the Satisfactory assessment of the transition impact of the six case studies presented by EvD in Section 3.5 and the TIMS ratings of the same projects.

- Management disagrees with some of the project ratings in the study in relation to financial performance and Bank handling as they are not based on an in-depth analysis of the summary of projects and how they were structured. The study asserts that it is critical that the MEI team should be more proactive in rebalancing contracts, which is a very fine line for the Bank to tread. For example in Zagreb, the profits of the water PPP have been criticised but these have been the result of the efficiency of the operator, which is something the Bank advocates.

- Management questions the study comment in Section 4.3, EvD about the rationale for including PSP components in MEI public sector projects. Management agrees with the assessment in the report on page 35-36 that the diversity of new PSP activities promoted by MEI during the last 2009-2012 period demonstrates MEI's willingness to be pro-active and innovative, as new opportunities have arisen in the municipal market. There are different forms of PSP, which span from the classic long term concession to new models, like:

    - Automated fare collection (smart card ticketing) which is being pursued through TC support in Arad and Almaty and was financed in 2013 in Budapest under a Design-Build-Operation-Maintain (DBOM) contract.
    - Private bus operations, where MEI is pursuing a variety of different models, including 'asset leases', where the public sector mobilises the financing and owns the bus fleets, but leases out the units to private sector operator(s) on a performance basis using Public Service Contracts (this is being pursued in Almaty, for example). Other cities (Budapest, Warsaw and Belgrade for example) have introduced fully out-sourced private bus contracts, where the fleets are privately financed and privately owned. This requires a strong regulatory authority.
    - In Moldova water, following a prefeasibility study and assessment of the market, the consultants recommended restructuring the concession more in line with a short term management contract as opposed to a classic concession.

- Municipal roads: the introduction of PSP using performance-standards for rehabilitation and ongoing maintenance contracts can also be pursued on a selective basis. An example is currently under preparation in Buzau, Romania.

Yet, based on the low success rate, the study concludes that the main rationale for including PSP components in MEI public sector projects is to artificially boost the ex-ante TI potential rating. Management would like to stress the following considerations in relation to the nature of such MEI projects:

- It should be noted that most of the types of projects cited (e.g., parking PPP, ferries, e-ticketing, private bus fleet financing and urban road management) have been new to the Bank since 2008 and new to MEI's clients as well. In this sense, it is too early to form definitive conclusions on the ultimate success of these new types of PSP in MEI, especially in the urban transport sector.

- As with any innovation, there are risks inherent in the PSP-oriented projects prepared by MEI since 2009. These risks have been transparently noted by the Bank notably by OCE in Transition ratings – typically "High" risk.