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Poznan Waste-to-Energy Project, Poland

Using EU Funds in PPPs Case Study

June 2012

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Terms of Use of this Publication

Context of this Publication

This report is part of EPEC's work on Combining EU funds and PPPs and is published alongside the stock take of blended projects in the EU. EPEC is grateful for the assistance provided by our EPEC member in Poland – the Ministry of Regional Development – in the compilation of this report.

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1. Introduction

This case study is part of a series being prepared by EPEC on projects that have combined or have attempted to combine EU funds[1] with a public-private partnership (PPP) structure. It provides background information on the Poznan waste-to-energy project (the "Project") in Poland, highlights the strategy adopted by the local public authority in relation to both procurement and the EU grant application and provides insights on ways of addressing known challenges[2] in blending EU funds and PPPs. This case study looks into a project that is still being structured and negotiated. As the Project evolves, EPEC will report on the progress made on the issues raised, providing "live" insight into the evolution of the Project. This first release presents the situation of the Project as of December 2011.

The study starts with a brief description of the Project, its scope and its preparation stage, and the key business and policy drivers for the municipality, and then discusses some of the challenges the Project is facing in terms of blending. This case study aims to explain how blending challenges are being addressed in this specific case and highlights those that still need to be addressed. It does not focus on other PPP-related challenges unless they are intimately related to or potentially have an impact on the capacity of the PPP project to combine EU funds and of the private sector to effectively leverage the blended project.

2. Project Background

In order to comply with new national and European environmental standards on waste disposal,[3] a number of Polish cities and regions have in the current programming period (2007-2013) commenced project preparation for the construction of waste incinerators. The projects in question are consistent with national and regional strategic documents and the objectives of the Polish Operational Programme Infrastructure and Environment 2007-2013 (OPI&E)[4], making them eligible for EU grant co-financing, with grant amounts reserved for their co-financing. Up to PLN 352 million (approximately EUR 84 million)[5] has been pre-allocated to the Project by the Polish managing authority under the relevant Priority Axis. The cities of Bialystok, Bydgoszcz-Torun, Gdansk, Koszalin, Krakow, Lodz, Szczecin and Warsaw have already announced plans to build similar infrastructure but only Poznan has so far chosen to go ahead with a PPP structure, although Gdańsk, Koszalin and Łódz are also considering procuring the infrastructure via a PPP structure.

The waste-to-energy project of the City of Poznan ("the City") is one of the most advanced cases in Poland of a greenfield project attempting to combine EU funds (from the Cohesion Fund) with a PPP structure. Hence its selection for this case

[1] In this paper "EU funds" refers to funds made available by the Commission to Member States under either the European Regional Development Fund, the European Social Fund or the Cohesion Fund.

[2] See "Using EU Funds in PPPs - explaining the how and starting the discussion on the future", EPEC report, May 2011, **www.eib.org/epec/resources/epec-using-EU-funds-in-ppps-public.pdf**.

[3] National Waste Management Plan 2014 (NWMP 2014), adopted by the Government of the Republic of Poland in December 2010, and the new Waste Framework Directive 2008/98/EC.

[4] The Project is being implemented under Priority Axis II (*Waste management and the protection of the earth*) and Measure 2.1 (*Comprehensive undertakings in the scope of managing municipal waste with particular attention to hazardous waste*). The main objective of Priority Axis II is to increase economic benefits by reducing the amount of municipal waste disposal. The maximum level of co-financing under this axis is set at 85% although it does not mean that projects will reach this co-financing level.

[5] EUR 1=PLN 4.18 as of 25 April 2012.

study. Even though blending PPPs with EU funds is feasible in the current financial climate, relatively few projects where the private sector effectively leveraged the project have succeeded in Europe and only one is known to have succeeded to date in Poland, on a much smaller scale and involving far less complexity.[6] The development of the project in Poznan is closely followed by the Polish Ministry of Regional Development and the Commission. Other Polish cities are expected to follow suit, possibly in the next programming period (2014-2020), if the Poznan case proves successful in terms of both PPP structure and its capacity to blend.

As the Project's investment cost exceeds EUR 50 million, it qualifies as a "major project" under Article 39 of the Council Regulation laying down general provisions on the EU Funds[7] (the "Funds Regulation") and is subject to decision by the Commission.

[6] See "EU Funds in PPPs – Project Stocktake and Case Studies", EPEC report, June 2012, **www.eib.org/epec/resources/project_stocktake_eu_funds_in_ppps_public.pdf**.

[7] Council Regulation (EC) No 1083/2006.

Project Highlights

Project area:	City of Poznan and nine surrounding municipalities (Miasto i Gmina Buk, Gmina Czerwonak, Gmina Kleszczewo, Miasto i Gmina Kostrzyn, Miasto i Gmina Murowana Goślina, Miasto i Gmina Oborniki, Miasto i Gmina Pobiedziska, Gmina Suchy Las, Miasto i Gmina Swarzędz), with a population of approximately 730,000 inhabitants
Incineration capacity:	210,000 tons/year
Estimated capital cost:	PLN 794,513 million
EU co-financing:	Up to PLN 352 million reserved for the Project, subject to approval and funding gap calculations
Heat offtake:	Not finalised
Electricity offtake:	Regulated preferential green electricity offtake
Land acquisition:	Land acquisition agreement finalised during tender process
Environmental Impact Assessment:	Phase I assessment completed, Phase II to be completed by selected private partner based on technical solution adopted
Waste generation:	Aggregate estimated at 335,000 tons in 2020.
Procurement status:[8]	Tender announced on 4 April 2011 List of 11 qualified interested bidders published on 7 June 2011 Shortlist of five bidders published by the City on 13 September 2011 While the competitive dialogue started in Q4 2011 and will continue in Q1 2012, the City hopes bidders will be able to provide their best and final offers by the end of September 2012

The Project is expected to be co-financed by the private sector partner, EU funds and the City. The possibility of a concessional loan from the Polish National Fund for Environmental Protection and Water Management (National Fund) is being considered. The Project provides for procurement for the construction, maintenance, financing and operation of a waste-to-energy plant complying with the relevant national and European standards, including the EU Directive on waste incineration[9], for an expected contract period of 30 to 35 years, structured as an availability scheme.

In addition to sound municipal waste treatment for the City and the nine surrounding municipalities, one of the objectives of the city of Poznan in implementing this project

[8] As of December 2011.

[9] Directive 2000/76/EC of the European Parliament and of the Council of 4 December 2000 on the incineration of waste.

is to minimise its financial contribution. Ideally, the City would like the Project to be entirely financed by the private partner's equity, the grant contribution and debt financing obtained by the private sector. This may be difficult to achieve given that for revenue-generating projects such as this, the beneficiary is by definition required to contribute towards the funding gap since the EU funds will only partially finance such a funding gap.[10]

Given the City's goal of minimising its financial support for the Project, the backstopping of the grant availability and amount by the City is therefore not an option (i.e. the City needs confirmation from the managing authority that the grant will be available). Unlike in the case of other projects, where the granting authorities took upon themselves the risk of the amount and availability of the grant, the City does not appear to be prepared to assume this risk at this point in time. As a result, dealing with the grant/loan blending issues listed below is more complex than in the case of blended projects where the grant availability and quantum were effectively backstopped by the public authority. At the time of writing, the City expected to limit its financial contribution to approximately EUR 15 million (or 8% of the estimated financing requirement). It is also important for the City to ensure that the Project (and its associated debt) is recorded off-balance sheet for purposes of the European System of National and Regional Accounts (ESA 95)[11] and national budgetary rules.

3. Grant/Loan Blending Challenges

There are number of known challenges in combining EU funds and PPPs.[12] This section looks into how the Project is approaching some of these challenges, such as the timing of the grant application, the approach to the funding gap analysis and how the grant will be effectively channelled to the Project.

3.1. Timing of Submission of Grant Application

In relation to a revenue-generating PPP project, the public authority normally needs to decide either to:

(i) **PPP Selection First - Grant Application Second:** file the grant application after having selected the private sector partner in order to have the benefit of its final offer to be able to calculate more precisely the funding gap required for the grant application, or

(ii) **Grant Application First - PPP Selection Second:** proceed with the grant application based on in-house projections and seek a decision on the grant before the selection of the PPP partner, in order to be in a position to confirm to the latter the quantum and certainty of availability of the grant.

Although the Funds Regulation gives beneficiaries considerable leeway over the timing for submitting grant applications when projects are not competing for EU

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10 A surprisingly high number of potential beneficiaries believe that the national contribution towards the funding gap can be sought from the private sector partner. This is a misconception as, by definition, the funding gap represents funding that is not supported by sufficient revenues generated by the project and requires public support above and beyond that which can be provided by the private sector. This public support will in this Project take the form of an EU grant and a direct contribution from the City of Poznan.

11 See "Eurostat Treatment of Public-Private Partnerships, Purposes, Methodology and Recent Trends", EPEC, November 2010, http://www.eib.org/epec/resources/epec-eurostat-statistical-treatment-of-ppps.pdf and "Risk Distribution and Balance Sheet Treatment, Practical Guide", EPEC, October 2011, **www.eib.org/epec/resources/epec-risk-distribution-and-balance-sheet-treatment.pdf**.

12 See footnote 1 above.

funds,[13] in practice it is difficult to schedule the preparation and submission of a grant application in a way that interfaces smoothly with the PPP procurement process. It is often "a chicken and egg" conundrum: it is easier and more definitive to prepare the grant application based on a final offer received from the selected private sector partner, but bidders often need to know what the public sector capital contribution will be (whether it comes from the EU grant or the public authority's own resources) in order to finalise their offer.

In Poznan, the City started procuring the PPP project without knowing for certain whether a grant would be available and, if so, what the amount would be.[14] The plan is to file the grant application after concluding the competitive dialogue but prior to receiving best and final offers (BAFOs) from bidders. At the time of writing, expectations were that (i) the City would be in a position to file its grant application by the end of June 2012 (after having had the benefit of final competitive dialogue discussions expected to end in Q2 2012) and (ii) bidders would provide BAFOs by the end of September 2012. Under this scenario, finalisation of the grant application appraisal by the Commission would only be completed once the final bidder selection had taken place, so that a decision on the grant would be issued by the end of October 2012.

The City will not be in a position to confirm the grant availability or amount by the date of the deadline for bidders to provide BAFOs and is not willing to backstop the grant amount from its own resources. Bidders are therefore likely to be asked to submit offers contemplating 100% financing through debt and equity (i.e. not based on the assumption of any grant or major City contribution).

The City is taking a "halfway" strategy on the timing of the filing of the grant application and is planning to file the application neither before nor after, but rather during the procurement process. This is a rather unusual approach and one that EPEC has not seen so far.

Having had the benefit of the competitive dialogue will most likely allow the City to refine its funding gap calculations before submission but it is almost certain that the funding gap calculations used in the grant application will differ from the funding gap implied by the BAFOs. As a result, the difference between these funding gap calculations (application vs. BAFOs) means that the grant amount calculated in the earlier application will be different from the one based on the BAFO.

A positive difference between the two amounts (grant amount higher than the grant amount calculated based on the BAFO) exposes the City to a potential risk of having the grant recalculated and having to refund the difference if it is deemed material by the Commission.[15]

In the event of a negative difference (grant amount lower than the grant amount calculated based on the BAFO) a higher grant amount should have been requested. It is unclear how the City could address this issue other than by directly subsidising the difference (i.e. between the lower funding gap under the grant application and the

[13] This is the case for Poznan as EU funds have been reserved for the Project under the relevant operational programme.

[14] The grant amount "reserved" for the Project under the Priority Axis (in this case PLN 352 million) is only an indicative amount, and before the beneficiary can access these funds the Project must demonstrate that it qualifies for the grant and, if so, for what amount.

[15] See Section 4.4 of COCOF 07/0074/04-EN concerning Article 55(4) of the Funds Regulation, **http://funding.bridgend.gov.uk/index.php/convergence_2007_2013/eu_structural_funds_guidance/article_55_revenue_generating_projects**.

higher funding gaps presented in the BAFOs) or cancelling the tender if it does not want to compensate for this gap.

3.2. Funding Gap Calculation

The City and its advisers have prepared a base case that makes certain assumptions on, inter alia, tipping fees (one of the main revenue-generating components of the Project) and the capital costs of the Project, enabling the City to model the expected funding gap required to project the expected maximum grant amount. Notwithstanding the City's own initial funding gap calculations, the dynamics of the Project are complex and, depending on the technical solution put forward by the selected bidder, the associated investment costs and long-term maintenance costs, as well as the co-generating and heat offtake potential, may differ. Although the funding gap problem may be acute for this project, it is an issue faced by all beneficiaries in trying to determine the funding gap prior to having selected the private sector partner (and knowing the details of the final offer).

In order to reduce the risk of there being an important difference between the funding gap projected by the City (prior to the launch of the tender) and the actual funding gap based on the BAFOs, the City is considering a two-step approach for its funding gap analysis. It decided to wait for the conclusion of the competitive dialogue before finalising its application (and its funding gap analysis), in order to have a calculation that takes into account the latest competitive dialogue discussion and so have a more intimate knowledge of the proposals, short of having the actual BAFOs. As mentioned in Section 3.1, the City plans to file the application after the conclusion of the competitive dialogue but prior to the review of the BAFOs.

This appears to be a reasonable compromise between (i) filing an application early with a funding gap calculation that may differ materially from the BAFOs, in order to seek clarity on the grant issue prior to launching into the PPP tender, and (ii) filing the grant application after the selection of the private sector partner.

The consequences of not getting the projections of the financing gap calculation as close as possible to the actual financing gap of the Project (which will only be confirmed once the Project is implemented) may be important for the City. Its projected financing gap calculations could materially differ from those based on the private sector's final offer. With a PPP structure this risk is greater than with traditionally procured projects, as the private sector is requested to provide a service rather than asked to build a specific infrastructure. The range of solutions and approaches afforded to the private sector is much greater than with traditional procurement and the amount of the capital and maintenance costs may vary greatly. As EU funds will only co-finance a percentage of the capital costs (excluding the maintenance costs) not financed by the revenues generated by the project, the amount of the grant is much more volatile in relation to a PPP project than for one procured using traditional procurement methods.

In this case, this risk is partially mitigated by the decision of the City to file its application after the conclusion of the competitive dialogue but the risk still remains as the application will not benefit from the details included in the BAFOs.

It is interesting to note that, while all Polish cities planning an incinerator project initially indicated they would seek grant co-financing from EU funds, the city of Warsaw has now decided not to seek grant co-financing for its incinerator project. It is believed that grant support will not be sought given the self-financing potential of its incinerator project. This highlights the range of possible outcomes in calculating the funding gap of revenue-generating operations for similar projects within a given country and sector.

3.3. Channelling the Grant to the Project

Given the current Funds Regulation, only the City can be the "beneficiary" of the EU grant[16] as it is the initiator of the Project. As for any project combining EU funds and a PPP structure, the question of how and when the City can bring the EU Funds to the Project needs to be considered.

For an operation co-financed by EU funds and procured under traditional procurement methods, the beneficiary signs a contract for the works and pays contractors as the facility is being built. The beneficiary requests disbursement of the grant against eligible expenditures as and when payments are made. Under the current Funds Regulation for grants allocated in the 2007-2013 programming period, the beneficiary must have incurred and paid for expenditure by 31 December 2015[17] for it to be considered eligible for grant co-financing.

Under a standard PPP structure, the public authority should be paying the private partner over time as and when the (incineration) service is provided or made available to the public authority. Contrary to the provisions of the Funds Regulation, under a PPP structure the beneficiary is not paying for the infrastructure built for it but rather for services provided to it using the infrastructure. Of course part of the service payment is to pay for the capital cost of the infrastructure but part is also for its operation, maintenance and financing.

This service payment over a long period of time (beyond December 2015) conflicts with the imperative to have the grant disbursed by 31 December 2015.[18] As a result, the City must consider how to "pay" for eligible expenditures by the deadline in order not to forfeit the benefit of the grant.

According to guidelines issued by the Polish managing authority, the City may be able to designate the selected private sector partner as "an authorised entity to provide eligible expenditures"[19] for the Project. If this were in fact possible, it means that during the construction period, as eligible expenditures are incurred and paid for by the private sector partner, the City would not be required to prove that eligible expenditures have been directly incurred but would be able to present for reimbursement invoices for eligible costs incurred and paid for by the private sector partner in order to claim the grant. Assuming construction takes place (and is paid for) by the 31 December 2015 deadline, the City would be able to claim the grant. This approach recognises that the eligible costs have been incurred (and paid for) by the private partner "on behalf" of the beneficiary.

The above addresses the issue of how the City will be able to claim the grant but not how and when it would actually contribute the grant to the Project. Theoretically, the City could hold on to the funds received and disburse them as and when the service

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16 The definition of "beneficiary" refers to the public or private body responsible for initiating or initiating and implementing a project. In this case the initiator of the project is the City, so the City will be the beneficiary of the grant.

17 Article 56(1) of Council Regulation (EC) No 1083/2006.

18 Ibid.

19 "Guidelines for eligible expenditures in Infrastructure and Environment OP 2007-2013" issued by Polish Minister of Regional Development, No MRR/IiŚ/1(5)06/2011, **www.pois.gov.pl/Dokumenty/wso/Documents/20110621_Wytyczne_kwalif_POIS_po_akceptacji.pdf**.

payment is due and payable to the private partner in order not to upset the risk/incentive matrix of the PPP. In practice, notwithstanding the schedule of the service payments, whether the Commission will require the funds to be immediately transferred from the City to the private sector partner remains to be seen. In any event, given the choice, the City may decide to make a prepayment on future service payments to reduce the private partner's financing costs in exchange for a reduction in the service payments over time. This may be an efficient use of the grant funds made available.

Should the City be required or elect to "frontload" the grant amount into the Project via a prepayment towards future service payments rather then disbursing it over time as and when the (incineration) service is provided, there is a risk that this will upset the risk profile of the PPP structure. The City will need to ensure that the private sector partner remains sufficiently incentivised and that this upfront contribution does not prevent it from reaping the benefits of the PPP structure.

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