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Using EU Funds in PPPs - explaining the how and starting the discussion on the future

May 2011

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Introduction

Purpose of the paper

The European Commission's *Communication on Public-Private Partnerships (PPPs)* of 2009 set out a commitment to support the financing of PPPs by introducing new financial engineering instruments. It also indicated that the European Commission ("Commission") was looking for ways to make the combination of European Union (EU) grants and PPP structures more attractive and accessible. The following note, which is complementary to the recent JASPERS guidance¹, presents the instruments currently available for combining PPPs with EU Funds. It highlights the main challenges involved in blending and offers conclusions.

Background

EU Funds are already a major source of European infrastructure finance with EUR 347 billion of cohesion funding and EUR 8 billion of Trans-European Networks-Transport (TEN-T) funding for the current budgetary period 2007-2013. Although co-financing rules differ across these instruments, all require matching co-finance, more of which could come from private sources.

In some circumstances PPPs may deliver better grant-funded projects than classical procurement. A European Investment Bank (EIB) evaluation report on PPP projects in different regions of the EU found that PPPs tend to be characterised by professional project management and implementation, project delivery on time and on budget, an improved asset and service quality as well as a life-cycle approach defined performance standards throughout the contract period. It also highlighted 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 procurement². This is an important aspect as private finance can help to raise the necessary co-financing in EU grant-funded projects. It should be noted that the potential advantages of PPPs vary with the Member State and sector and the value for money aspect of the options available requires careful scrutiny in all cases.

But while PPPs can help grant funded projects to happen, the converse is also true: In some cases, EU funding programmes have been used to improve the risk profiles and strengthen the contractual arrangements of PPPs, so increasing their marketability.

¹ JASPERS have prepared two Working Papers in the area of PPP-grant blending; these are available on the JASPERS website at <http://www.jaspers-europa-info.org/index.php/workpap/129-hcswp.html>. The first presents a range of models for the application of EU grant funding in PPP projects for large scale infrastructure, and the second covers the application of EU grant funding in greater detail specifically under Design-Build Operate structures.

² The Report can be found at http://www.eib.org/attachments/thematic/eib_ppp_en.pdf.

Even though using EU Funds for PPPs is feasible, relatively few projects that have used this opportunity have come to market since 2007. One of the main reasons is that the majority of grant schemes has been designed for capital contributions, which may sit uneasily with some types of PPP models. This issue is further elaborated later in this note. The Commission and EPEC have agreed to undertake work during 2011-12 in preparation for the next budgetary period with the aim of facilitating the combination of PPPs with Structural Funds. By then conventional government co-financing may be even more difficult to find and there may be a wider political recognition of the benefits of PPP and its whole-life approach to project design, delivery and management.

Structure of the paper

This paper focuses mainly on Structural and TEN-T Funds, but the principles also apply to other existing funding for EU policy priorities (e.g. Environment, European competitiveness, New Generation Access). It is concerned primarily with the impact of EU level regulations on PPPs; it does not cover the issue of the interfaces between these regulations and national law, regulation and practice. These interfaces are important and should be considered carefully by those EPEC Members wishing embark on a programme of grant / loan blending³.

The structure of the paper is as follows. Following this introduction:

- Section 1 examines the principal instruments available for blending EU Funds with PPPs;
- Sections 2 and 3 analyses some of the main difficulties encountered related to both the application of EU regulations (section 2) and wider policy and procurement issues (section 3);
- Section 4 examines further the scope for developing PPP within the current framework of regulations;
- Section 5 considers the changes to the regulations which may be desirable to maximise the potential for PPPs.

Three Annexes give more details on some of the main topics of this paper:

- Annex I on financial engineering instruments as a means of combining EU Funds and PPPs;
- Annex II on how to blend PPPs with TEN-T Grants and the TEN-T grant application process;
- Annex III on how to blend PPPs with Structural Funds⁴ grants and in particular the issue of the funding gap and of the grant application for Structural Funds.

³ EPEC will be looking to issue further guidance on this issue in due course.

⁴ Structural Funds in this paper means the funds regulated through Council Regulation (EC) No 1083/2006 of 11 July, 2006, laying down general provisions on the European Regional Development Fund, European Social Fund and the Cohesion Fund (the General Regulation).

1. Instruments for blending PPPs with EU Funds

EU Funds can be combined with PPPs in a variety of ways, of which co-financing is only one. The European Commission has made three different groups of instruments available to PPPs:

- Financial engineering instruments that leverage private finance – in other words, enabling private finance to be used where it would not otherwise have been the case;
- Sectorally focused grants that incentivise promoters to undertake projects in the pan-European interest;
- Grants that support the cohesion policy of the Union and individual EU Member States.

These instruments address different needs, and are directed at different authorities.

1.1 EU Funds for financial engineering

The main reason for the Commission to offer financial engineering instruments for PPP projects is to support the provision of important infrastructure and the need to bridge certain market gaps, which are not yet addressed by other parties. The funds for financial engineering are targeted at the private sector and are of potential interest to public sector authorities involved in the procurement of PPPs. They apply where a PPP project encounters difficulties in establishing an acceptable financing scheme. In this case, certain clearly-defined project risks associated with PPP projects are assumed by EU Funds from different EU programmes. An example is the Loan Guarantee for TEN-T projects (LGTT), which is a loan guarantee product specifically designed and administered by the EIB for TEN-Ts. The Commission and the EIB jointly fund it. It mitigates the traffic risk in the early stage of a transportation project when user-generated revenues experience significant fluctuations that can hamper access to competitively-priced private funding. By removing one of the major obstacles to the financing of such project, the EU Funds help to bridge a financing gap and thus facilitate the execution of a project. Project examples include the A5 motorway in Germany, the C25 in Spain and the EP4 in Portugal.

In addition to such project risks, the EU has identified the lack of sufficient equity for large infrastructure projects as another bottleneck for the realisation of PPPs. This is why the Marguerite Fund has received the active support of the Commission, who has also contributed to the Fund's seed capital, as part of the European Economic Recovery Plan. The Marguerite Fund is a pan-European equity fund which aims to act as a catalyst for infrastructure investments implementing key EU policies in the areas of climate change, energy security, and trans-European networks. Marguerite is also the first joint initiative of Europe's leading public financial institutions, including the EIB.

Furthermore, through the support offered by the Structural Funds programmes, JESSICA, another joint venture between the EIB and the Commission, can provide financing in the form of loans, equity and guarantees, which can include offering mezzanine financing to municipal PPPs in order to reduce the credit risk for senior lenders. In an environment where relatively small projects attract small private sector companies, which are strong on experience but short on equity, JESSICA funds can provide an (additional) layer of subordinated funding ranking between equity and bank debt and thus increase the attractiveness of the senior debt to banks. The first

examples of this are currently being prepared as part of the Lithuanian and the Greek PPP programmes.

EU-funded financial engineering instruments are mostly revolving facilities, i.e. they do not reach the final beneficiaries as grants, but have to be reimbursed so that they can afterwards be reemployed by the public authorities.

1.2 Sectoral grants to promote investments in pan-European policy priorities

The Commission provides a number of grants to incentivise projects of pan-European importance, e.g. trans-European networks, environment and climate change mitigation, European competitiveness. The grants for trans-European transport networks provide a good example for the mechanics of these grants.

The EU grants to promote investments in TEN-T are of potential interest to public sector authorities involved in the financial planning of TEN-T projects. The majority of available TEN-T grants are offered to support studies or works, which contribute to the TEN-T programme priorities such as cross border linkages, environmentally friendly transport, removing bottlenecks and pan-European traffic management systems. TEN-T funding opportunities are open to all EU Member States and, with the agreement of the Member States concerned, explicitly also to joint undertakings and PPPs.

The TEN-T Executive Agency, closely linked to the Directorate-General Mobility and Transport (DG MOVE) responsible for managing the technical and financial implementation of the Trans-European Transport Network (TEN-T) programme, currently manages over 300 individual grant decisions. There are some large PPPs within the TEN-T and grants have been used to support studies for the project preparation phase, such as the Portuguese High Speed Rail project, RAVE. In the 2010 Annual Call, funding was explicitly offered for the first time for feasibility studies for projects with PPP potential and for studies to bring PPPs to maturity. With respect to the funding of works in PPPs, there are no explicit restrictions. The TEN Regulation include a grant developed to support construction works in the context of availability payment schemes, although deficiencies in its design have limited its use. These issues are discussed more fully in Section V.

TEN-T funds are made available as free grants to promote and incentivise projects that implement TEN-T schemes.

1.3 EU Structural Funds grants

The Commission makes EU Structural Funds available to support the cohesion policies of the Union and individual Member States. The respective Managing Authority of the Member State processes these grants. In most cases, the public entity is interested in combining such grants with PPPs because it wishes to source the necessary co-financing from private funds and/or it sees value in an off-balance sheet treatment of the underlying asset. When assessing the mechanics of combining the grants with PPPs the respective Managing Authority would normally work in cooperation with the public sector entities involved in the procurement of PPPs.

Structural Funds and Cohesion Fund

The Structural Funds and the Cohesion Fund are funds allocated by the European Union as part of its regional policy. They aim to reduce regional disparities in terms of income, wealth and opportunities. Europe's poorer regions receive most of the support, but all European regions are eligible for funding under the policy's various funds and programmes.

The Structural Funds are made up of the European Regional Development Fund (ERDF) and the European Social Fund (ESF). New objectives have been defined for the current programmes, which run from 1 January 2007 to 31 December 2013. The overall budget for this period is EUR 347bn: EUR 201bn for the European Regional Development Fund, EUR 76bn for the European Social Fund, and EUR 70bn for the Cohesion Fund.

Objectives	Structural Funds and instruments		
Convergence	ERDF	ESF	Cohesion Fund
Regional Competitiveness and Employment	ERDF	ESF	
European Territorial Cooperation	ERDF		

The Structural Funds grants offer the largest amount of funding that is potentially available to PPPs, both as a whole and on a project basis. They can come either as a defined percentage of construction costs of non-revenue generating projects (e.g. untolled roads) or a variable grant to bridge the funding gap in revenue-generating projects (e.g. waste incinerator, toll road). Where an economically worthwhile project which generates some revenue is, nevertheless, unable to meet the whole of its costs from user charges, it can apply for EU grants. The maximum grant is the amount that is sufficient to make the project financially viable. This is known as the 'funding gap'. The beneficiary of the grant has to be a public sector entity but the funding can subsequently be made available to private partners in a PPP provided certain key principles are observed (i.e. mainly procurement and state aid rules)⁵. This instrument does not necessarily reduce the credit risk of the underlying project, but without such a grant, the project would not be feasible as PPP. A good example would be the Greek Rion Antirion Bridge.

Structural Funds grants are also made available as non-repayable contributions, but the rules that allow applying them in PPPs are very different from TEN-T funds and they are managed by different counterparts on both sides of the application process.

⁵ This is at least established practice, although the rules do not seem to prohibit explicitly grant applications directly by the private sector.

2. The challenges for combining PPPs and EU Funds

In spite of the potentially positive features of combining EU Funds and PPPs and of the instruments already available, there are not many successful examples of projects of this kind. Some of the reasons for this are to be found at the level of EU fund recipients: There are not many PPP projects in general in the EU-12 countries, which are the major recipients of the Structural Funds, mainly because these countries have often limited public sector capacity to deliver complex project structures, both at central government level and even more so at regional and municipal level. They also have organisational bottlenecks. In many cases, the officials involved in administering EU Funds are not the same as the ones involved in the planning and procurement of PPPs. In these circumstances, the 'public-public' partnership, which is a necessary precondition for establishing PPPs, does not always work. Lastly, national legislation is sometimes not adapted to allowing certain combinations of EU Funds and PPPs or certain structures of blending.

The various instruments for combining EU Funds and PPP also have significant differences in their implementation requirements. Some are inherently more amenable to PPPs, and this may explain why these instruments have been applied more than others. For example, a financial engineering instrument like LGTT was set up particularly to mitigate project risks in transport PPPs and was thus designed for PPPs. Similarly, JESSICA rules explicitly target PPP as one of its uses. Evaluation studies are offered by the Commission in cooperation with EIB, which help with targeting and use of the instrument. Further, TEN-T funding as a means of project incentivisation also allows for grant disbursement to private partners and both its rules and its application process are favourable for PPPs.

The application of Structural Funds grants for PPPs, on the other hand, which is also by far the largest amount of potential funding available, requires more attention. Here the complexity varies according to the nature of the funding, the ownership of the assets, the time necessary to implement the investment, etc. It is important to understand and highlight the main areas of difficulties encountered during this budgetary period in order to initiate change and to facilitate the combination of EU Structural Funds and PPPs for the next Financial Perspective.

The main organisational complications inherent in the grant application process for Structural Funds grants include the following:

2.1 Planning

The first challenge for the public authority in charge of an investment project is often already in the project planning. Evidence from successful blended projects suggests that it is of particular importance to consider the grant element and the timetable for the grant application from the very beginning of the project planning to ensure success. The project has to be included in the relevant Operational Programme under the National Strategic Reference Framework and the implementation has to respect the disbursement periods of the budgetary programme. Given the requirements of the grant rules, countries which have been successful in blending EU grants and PPPs have tended to treat the project as principally grant funded, but co-financed by a PPP, rather than trying to fit a grant into an already designed PPP structure. The grant application is the less flexible component and therefore needs to be at the core of the planning.

The EU Structural Funds have been designed to co-finance capital investments within a restricted period from the time of their programming (under the relevant Operational Programme) or, in case of major projects over EUR 50 million, their approval. This period is usually two years (although it may be three years in certain circumstances). This is sometimes known as the N+2 rule. If the deadline applicable to the N+2 (or N+3) rule cannot be met, this may result in a loss of part or even of all of the grant funding. For the current EU budgetary period, grants need to be fully disbursed by 31/12/2015. Given the long planning, procurement, documentation and financing periods necessary to procure a PPP, it is a major challenge to ensure grant disbursements within the deadlines. EU rules permit that grant funding be approved after a project is already implemented or under implementation, but this carries a different risk that the public and private sectors must commit themselves to the project before it is known whether the Commission will approve the project and confirm its funding. Legally, the timing of approval is not relevant for major projects. Projects can be commenced before formal grant approval, with the grant used to refinance later. Many beneficiaries start implementing major projects before approval, and many Member States encourage and support them in doing so. After the latest amendment to regulation 1083/2006, major projects can even receive payments from the Commission before its decision to confirm co-financing.

2.2 Funding gap analysis

In the current budgetary period, revenue-generating projects will only receive a grant from the Structural Funds towards the 'funding gap' and the Commission has issued guidelines about how this gap has to be calculated.⁶ This is to ensure that the EU grant only funds a project up to the point at which its grant funding, combined with national grant co-financing, enables profitability and sustainability to be achieved.

The funding gap rules apply identically to all revenue-generating infrastructure projects, whether PPP or not, because they relate to revenue generation and not the financing structure of the project. Therefore in principle there should be no difference in the grant rate for a project funded under a PPP or a different structure. However, certain difficulties apply in the case of a PPP project:

- The funding gap approach implies that in the case of revenue-generating projects (e.g. waste incinerator) there must always be a national grant co-financing alongside the EU grant. This means that a revenue-generating project could never be fully funded by the private financing from the PPP and the EU grant. This is not understood by some Management Authorities which consider PPP as a solution which would not require national grant resources to be committed;
- In cases where a grant is approved under a structure with no forecast revenue generation (e.g. an un-tolled road) but the charging structure is later changed (e.g. the road is subsequently tolled), part of the grant funding would be clawed back. The revenue system must therefore be identified and kept in place during the life of the project;
- It may also be advisable to introduce up-side revenue sharing arrangements between the private and the public sector to avoid the reputational risks

⁶ Please also see Annex III. It should be noted that some countries argue that for projects subject to state aid rules, an exemption under Art. 55(6) applies. Otherwise, a different set of rules, quite often more relaxed, apply, in particular under the so called regional state aid guidelines.

associated with windfall gains to the private sector in cases, in which revenues dramatically exceed initial forecasts. It should be noted that in the case of excessive private sector gains, the validity of the original projections could be challenged by the Commission during an audit, with a risk of clawback of grant;

- In a PPP the funding gap may be different for every bidder, in particular if the PPP is tendered using a selection criterion of the lowest tariff or toll, which impacts directly the amount of revenue and the funding gap. This makes it difficult for national authorities to present grant applications prior to the completion of PPP procurement (as often only then will the funding gap be known), and where applications are submitted before a PPP is awarded, it makes it difficult for the Commission to approve the proposed grant level. This may therefore imply a parallel process of PPP procurement and grant application steps, with well-defined interfaces, as well as consideration of tender award criteria, which do not impact the funding gap (e.g. the duration of a concession).

Generally, there is currently an absence of sufficient 'case law' on a number of these issues – this can lead to uncertainty for Managing Authorities, DG REGIO staff and the private sector. This may be particularly problematic in the case of a PPP where commercial lenders who are required to take project risk will require absolute certainty that sufficient funding has been put place to enable construction to be completed and operations carried out to the standards set out in the specification.

2.3 Timing grant application and PPP procurement

Although the Structural Funds regulations give considerable freedom to beneficiaries over the timing for submitting grant applications, in practice it is difficult to schedule the preparation and submission of a grant application in a way which will interface smoothly with the PPP procurement process. In particular, a choice has to be made as to whether to submit the grant application and gain certainty over its approval before financial close of the PPP (which reduces risks to the private sector over grant availability and therefore may encourage more bidders) or procuring the PPP first so that the project revenues and structure can be more accurately described in the grant application (which could increase the chances for a successful and shorter grant approval process). Either approach is possible, and the choice will depend on the project itself, the size of grant funding in total funding, the nature of the in-country approval process, and the risk appetite on the part of both the public and the private sector.

Whilst EU rules permit grant funding to be approved after a project is already implemented or under implementation, this carries the risk that the public and private sectors must commit themselves to the project before it is known whether the Commission will approve the project and confirm its funding. In practice, this is a major problem for a 'project financed' PPP structure where lenders will wish to be assured that the full construction financing has been contractually assured before committing themselves to a project. For this reason, a possible solution could be the choice of a so-called 'Design / Build / Operate' (DBO) project which, whilst retaining some aspects of a PPP structure, removes from the private sector responsibility for securing capital funding⁷.

⁷ Please also see Annex III.

2.4 Channelling the grant to the private partner

Although private entities can be beneficiaries under the rules of the Structural Funds, beneficiaries must also be “initiators” of a project. In practice this means that “private-private” projects can work with private beneficiaries, but under a PPP it is only the public sector that can be the initiator, and therefore beneficiary. It is the public entity that has to sign the grant application and that will ultimately receive the money against proof of expenditure.

There are four main ways in which the Structural Funds can be combined with private finance in PPP projects. In practice, some of these models have proved more deliverable than others. However, all are in principle applicable and have been used by countries, which have combined grant funding from their own national resources with PPP structures.

- Grants as public capital expenditure contribution: In this model, grant is used to part finance directly the capital costs of an asset. Availability or user charges are reduced as a consequence. In many respects this model is well adapted to the Structural Funds regulations as grants are used to finance directly capital expenditures. The model is, however, less well suited to the philosophy of PPP where remuneration of the private partner should be related to services delivered rather than costs incurred.
- Parallel co-financing: This involves the ‘splitting’ of an infrastructure asset or programme into (at least) two discrete parts, one of which is financed from public sources (incl. the EU grant) as a conventional procurement, the other as a PPP. The two elements of the project may subsequently be operated as a single concession, with availability or user charges below the level that would have applied to a full PPP procurement.
- Grants as means of part funding availability or user related (e.g. shadow toll) payments: This is arguably the ‘classic’ model for blending grants with private finance, in the sense that it matches most closely the fundamental principle of PPP that payments to the private sector should be related not to costs but to service delivery. However, it is also the model which has, in practice, been the most problematic to deliver with Structural Funds grants mainly due to the n+2 rule.

In practice this means that unlike PPPs, EU Structural Funds grants do not have a whole-life approach *per se*, but focus exclusively on the provision of assets. They are therefore oriented to co-financing a portion of construction costs, and not paying for an infrastructure-based service as under most PPPs. There is a cut-off date of 31/12/2015 beyond which no payments are possible under the 2007-2013 funding programme. For example, in an availability-based PPP, the private sector would construct an asset and then “lease” it out to the public sector, i.e. the public sector would only start paying for the service after project completion, typically over a long period of 20-30 years. EU grants have been designed as upfront payments towards the construction costs, and therefore although they could co-finance availability payments up to 2015, they could not support the main period of availability payments which would stretch beyond. This makes EU funding difficult to use for non-revenue projects like social infrastructure. Up-front capital contributions can be made, but if large, these can distort the risk profile and violate the “no service no payment” principle.

The timing incompatibilities would also apply to the EU grants to promote investments in TEN-T. The TEN Regulations require the project to begin within two years of the start date of the project and the first partial payment to be made within three years of

the funding decision. If the grant is awarded before construction starts, in order to provide leverage to the financing of the PPP, then it must be well-timed to meet these constraints and the grant will almost certainly need to be awarded to the consortium in order to meet the three year limit. This is not unreasonable if the grant is to be awarded against construction costs because they are initially borne by the private sector. The cycle of funding linked to the 7 year EU budget cycle is not compatible with the schedule of availability payments, which typically extend to 30 years or more. This is inconsistent with the principle of whole life costing, particularly when the grant is only available to offset construction costs, which is currently the case.

One solution to the issues raised in this section is the investment fund model. Under this model, Structural Funds would be combined with public and private financing in an investment fund which invests in a portfolio of PPP (or other) projects via repayable instruments. This has the further advantage that the Structural Funds invested are 'recycled' and the capital and returns can be re-invested. The JESSICA model (in which Structural Funds are disbursed to Urban Development Funds, UDF, in some cases via a Holding Fund) works on this basis.

2.5 Criteria for the selection of the private partner

In most PPPs the tender selection criterion focuses on the fee for delivering a service, be it a road toll, a water tariff or some other fee. Where EU funding is applied, it may be beneficial to apply other criteria, such as service quality achieved, extent of additional investment provided, duration of the concession, or even competition for minimum level of grant required. This could make it easier to tackle the funding gap issues (see above), but may also stimulate achievement of project objectives (e.g. if criteria are linked to project objectives), and they may impact state aid treatment. They may also facilitate the timing of grant and PPP procurement processes and interfaces. It would be helpful to analyse further the application of such criteria in the market and to explore their implications for EU grant funding.

3. Unresolved issues for combining PPPs and EU Funds

In addition to the challenges in particular for using EU Structural Funds grants, there are several unresolved issues for all grants at EU level that need urgent attention so as to be prepared for the next Financial Perspective. With respect to certain of these issues, a resolution of the grey area could provide immediate stimulus to the development of PPPs:

3.1 Statistical treatment of PPPs

The statistical treatment of PPPs matters to many governments. They see PPP as a solution to initiate new infrastructure investment without affecting their financial stability and their debt ratios, as they pass a majority of risk for the provision, operation and maintenance of the new asset to the private sector. In general, Eurostat's rules foresee that any PPP, which receives public contributions of more than 50%, has to be reported on the Government's balance sheet. In this, grants are treated as public contributions and as the aggregate of EU grants and national contributions has exceeded 50% for most past projects, they should have all been reported on the public balance sheet (and the associated debt counted towards the Excessive Deficit Procedure). Yet, this does not seem to be in the spirit of the Maastricht stability rules as an EU grant would not have a negative effect on the financial stability of the state in which the PPP is procured. A more appropriate approach would be to treat the EU grant as neutral and only to apply the risk distribution test to the costs that the private partner bears and the support that the project receives from the procuring authority.

3.2 Procurement of associated services

Similarly to the Eurostat treatment, the EU Procurement Directives foresees that projects, which receive public contributions of more than 50%, have to use public sector procurement rules. This would mean for a PPP project, in which grant and national contribution account for more than half of the investment cost, that the private partner would have to follow public sector procurement rules for its sub-contracting.

3.3 State aid

For Structural Funds, the beneficiary should always be a public sector entity. The grant is therefore not paid directly from the Commission to the project company, but has to be channelled through a national public body. This is treated differently by individual EU member states, but some national jurisdictions may consider such transfer as state aid. Complications arise, *inter alia*, from the way the grant element is advertised in the PPP tender, from the exact payment mechanism from the grant-receiving public entity to the private partner and from potential cost savings during project implementation, which affect the project cost and thus the profit of the private partner. The procuring authorities need a high degree of due diligence to avoid conflict with state aid regulations and rules differ across the EU. State aid would not be an issue if it were possible to draw the grant into a fund and apply it to subsidise the public sector's regular availability payments over the life of the project.

3.4 Demand for TEN-T funds

With respect to the development of PPPs within the TEN-T, the financial instrument designed specifically to encourage PPPs, the LGTT, has served and keeps serving its originally designed purpose, but in order to increase the number of transport PPPs that could benefit from it, further instruments based on the LGTT could be developed.

To date, the LGTT has been used in several PPPs, most of them toll roads, although a rail project with track access charges is considering its use. Although there is a solid pipeline of projects interested in utilising the LGTT, it has two limitations: (i) demand-based PPPs are primarily suitable for toll road projects. Road projects are not a top priority for the remaining TEN-T budget appropriations; and (ii) the trend in PPP arrangements is towards the availability payment scheme, in part due to the development of PPP arrangements for high speed rail and partly due to the more balanced risk allocation that can be achieved through availability payment mechanisms. Demand risk has two elements that are not controllable by the private sector – the presence of competitive alternative routes and macro-economic factors – making it a risk not easily transferable to the private sector.

4. What can be done until 2013 – with current regulations?

Strong efforts would be needed to push for more blended projects during the current budgetary period. Member States would have to improve their public sector capacity for delivery of complex projects and to overcome institutional and organisational bottlenecks. In addition, the private sector, consultants, banks and investors, would need to learn about possible blending structures and support their development.

This section summarises initiatives which could still be taken in the current budgetary period. Section 5 deals with issues that could be considered for adoption in the next budgetary period starting in 2014.

4.1 EU Funds for financial engineering⁸

LGTT has shown that blending EU Funds into PPPs works. The remit of the LGTT, which is currently restricted to revenue-based PPP payment mechanisms, could be expanded to mitigate early stage risks for any PPP payment mechanism (e.g. availability payment mechanisms). The LGTT could be re-designed to be as flexible as possible in its eligibility conditions to adapt to new developments in PPP arrangements, in terms of payment mechanisms and risk allocations. However, the procedure to amend the TEN Regulations requires a full co-decision procedure and could take several years. With regard to JESSICA, there are strong indications that JESSICA, once established by the Managing Authority responsible for the region, may become an important element in the financing of municipal PPPs. The instrument could therefore be marketed as such and package solutions offered. It may be worth exploring the establishment of a PPP financing facility along the lines of JESSICA, which could cover PPPs that are currently excluded from JESSICA for their sector and from Marguerite for their size.

In addition, new instruments should be considered, which can facilitate the financing of European infrastructure. The existing financial engineering instruments try to improve project structures and mitigate some of the project risks to make the investments more attractive to banks, investors, and sponsors. Yet, in times of unprecedented investment needs and an increased interest in PPPs, which coincide with a reduction of bank financing, attempts to attract new financial resources from private investors and pension funds need to be made. Bonds are long-term and can be cheaper than bank debt. PPP capital structures would, however, need credit enhancement to make them attractive as an asset class. Such underpinning could be made from EU Funds. EU guarantees or equity-like instruments (applied directly or, more likely, through the EIB) would sufficiently enhance the level of risk capital in infrastructure projects to enable the senior debt to reach investment grade. In turn, this should facilitate lending to the infrastructure sector, and ultimately also improve its liquidity.

4.2 EU grants to promote investments in pan-European projects

TEN-T funds have also been successfully used in PPPs especially to support studies. Similar incentive schemes could be envisaged for other EU priority areas like the

⁸ Please see also Annex I.

environment (potentially an expansion of the scope of ELENA, the *European Local Energy Assistance* supporting the mobilisation of funds for investments in sustainable energy at local level) and access to new generation broadband infrastructure.

With respect to using TEN-T grants for works, the following amendments to the financial regulations would be supportive:

- The grant could be applied for in advance of signing the PPP contract. This would provide the beneficiary with greater upfront certainty of financing. The normal Calls for Proposal cycle could be expanded to include Calls dedicated to PPPs or more frequent Calls could be held;
- The use of a fund or escrow account could be a useful intermediary to receive the partial payments in advance of the start-up of availability payments. The fund also provides some protection in the event of a failure of the PPP;
- The grant could be applied against the entire availability payment instalment rather than just the construction cost component, recognising it is a blended payment composed of construction, financing, operational and maintenance expenses;
- The co-funding rate could be increased to address the lack of long term grant support and to create better leverage from the TEN-T grant.

4.3 EU Structural Funds grants

Solutions and guidance on state aid, the statistical treatment and procurement rules should be relatively easy to produce. The more important issue is the funding gap analysis and the process alignment of the grant application and the PPP procurement. One possible solution is a process where grant application and PPP procurement can be run in parallel by determining a maximum grant component in the feasibility study, which is then used as the basis for the grant application, and then use the amount of grant funding as one of the determining tender criteria in the PPP procurement, i.e. a grant minimisation solution. Such grant minimisation would already work under present rules. However, the Commission should also ensure that the respective desk officers are fully aware of the options for blended PPPs. For the next Financial Perspective it would be desirable to simplify the funding gap analysis or even to replace it with new funding rules that would facilitate the use of PPPs in grant-funded projects.

4.4 Combining Structural Funds grants with financial engineering instruments

There are many projects, especially in transport, which are revenue generating, but where revenues are weak and can contribute only a part of the funding gap. Also, there may be cases where, even with substantial grant funding, the co-financing is difficult to raise. In such cases, it may be beneficial to combine Structural Fund grants with co-financing made available via financial engineering (e.g. grant + LGTT, or grant + JESSICA-backed soft equity). Although financial engineering instruments are exempt from the funding gap requirements, the Structural Fund grant funding is not, and the “grant equivalent” of the Structural Fund element may need to be taken into account in the financial analysis. It would be useful to explore how such co-financing could be achieved, especially as a precursor to the next programming period in which grant rates might reduce and the use of financial engineering instruments increase.

5. What could be done after 2014 – with new regulations?

Given the complexity of PPPs in general and of blended ones in particular, the development of models, standards, and modules that can be copied and repeated would help to create a wider range of options for funding. This would have to be accompanied by training of public sector officials at national and local level, but also of the desk officers of the Commission who have previously had little exposure to PPPs.

Modifications in the new regulations should take particular account of the following:

The “project initiator” wording in the present regulation’s definition of grant beneficiary should be modified to enable PPP SPVs to be grant beneficiaries. The benefits of this should be analysed further as well (e.g. VAT benefits as PPP SPVs can offset VAT payments on infrastructure against user charges, whereas public sector beneficiaries which are not VAT-registered cannot).

Mechanisms should be found to enable EU Funds to be applied to the co-financing of projects on an Availability or Service Payment basis, in addition to the present possibilities for up-front capex contributions. The key problem to solve is the application of EU funding to projects over the long-term, beyond the cut-off date of 2 years beyond the end of the programming period. A possible remedy which should be examined for the next Financial Perspective would be to allow the drawdown of Structural Funds and/or TEN-T grants into a fund or escrow account similar to the JESSICA and JEREMIE financial engineering instruments and the subsequent regular disbursement over the PPP contract period. Since such fund or escrow account would become and integrated part of the financing arrangements of a particular project, the grant could be deemed as having been paid out under the N+2 rules as soon as it reaches the fund. This mechanism would also need to permit the national contribution to be applied in line with the availability payments rather than via an up-front contribution to the account or fund. The “fonds perdu” concept underpinning present regulations would need to be reviewed in the light of such approaches, and a solution found to the question of what would happen if, after the end of the programming period, a PPP were to fail and paid out grant funds would somehow have to be left unused (e.g. they could be recycled as permitted for repayments under present financial engineering instruments).

Modifications to the funding gap approach should be considered, to remove present disincentives to structuring projects on a revenue-generating or PPP basis. It would be helpful to revisit the question as to whether, under a PPP, there is sufficient national commitment through the signature of a long-term PPP contract without the need for a national contribution as well (e.g. to enable, as in part programming periods, a project to be fully co-financed between EU grant funds and private financing under a PPP). In addition, if the funding gap approach is maintained, an alternative could be offered for beneficiaries for a lower flat percentage to be applied in circumstances, like in PPPs, in which make the funding gap approach is difficult to manage and where it would be unreasonable to refund over-financing after implementation.

Consideration should be given in the new regulations to co-financing between grant funds and loans or equity backed by financial engineering instruments, as this may be a useful approach for PPPs. The mechanism for calculating total grant equivalent should be described and the possibility for such co-financing specifically addressed and made permissible.

Conclusions

The recent Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee, the Committee of the Regions and the National Parliaments – The EU Budget Review of 19 October 2010 (the EU Budget Review Commission Communication) states:

“The impact of the EU budget can be magnified the more it can be used to leverage both funding and financing to support strategic investments with the highest European added value. Innovative financial instruments could provide an important new financing stream for strategic investments. The norm for projects with long-term commercial potential should be that EU Funds are used in partnership with the private and banking sectors [...] The Commission and the EIB have already successfully developed a number of common financial instruments. Blending between grants from the EU budget and loans from the EIB and other financial institutions has made it possible to treble the financial impact of EU external spending by attracting huge multiples of investment from financial institutions. This should be extended to become the norm in areas of long-term commercial potential, with new rules to govern blended instruments.”

PPPs are structures that rely to a great extent on private finance and as such are prime candidates for blending between grants from the EU budget and loans from financial institutions. The overview of current ways of combining EU Funds and PPPs presented in this paper and the experience under the current Financial Perspective point towards the following conclusions:

1. Financial Engineering Instruments

- The experience with the LGTT has been positive and the possibility of it being used for availability payment structures should be pursued.
- JESSICA will expand its relevance for the financing of municipal PPPs. To make its application more efficient, it should start designing and offering package solutions for PPPs where standardisation is possible (e.g. street-lighting projects, energy efficiency for public buildings).
- Given the positive experience with financial engineering instruments and the November 2010 Budget Review, it might be worth exploring the possibility of setting up an instrument which would be dedicated to PPPs that are excluded from Marguerite’s scope because of their size and IRR requirements and from JESSICA because they do not fall within its scope.
- It would also be worth exploring mechanisms for applying both grant and financial engineering to PPPs, as described earlier in this paper.

2. TEN-T Grants

- The issues of leverage and timing of TEN-T grants for works could be addressed by the grant application being filed in advance of commercial close and by establishing a mechanism under which the grant is applied against the obligation over time of the public sector to make availability payments (not only against the construction cost component of a project).

3. Structural Funds Grants

- The concept of the funding gap was introduced in the current Financial Perspective and the experience so far indicates that, however unintended, it makes the blending of PPPs with Structural Funds Grants difficult mainly because the exact “size” of the funding gap will often not be known until after commercial close. Therefore, it might be worth considering excluding PPPs from the application of the revenue-generating requirements for the next Financial Perspective, or redrafting the funding gap requirements in a way to make them more PPP-neutral.
- Solutions would be desirable that enable the application of EU grant funding to PPPs structured on an availability fund basis, where EU funding would need to be applied beyond the end of the cut-off period under the present regulations. This will be important to enable PPPs in areas of social infrastructure, and other low-revenue infrastructure, to benefit from EU funding without compromising the no-service-no-payment principle, and maintaining the advantages of the whole life approach.
- The lack of capacity or reduced capacity of contracting authorities at national, regional or municipal level, and in particular in the EU-12 Member States, is another reason that prevents the successful blending of PPPs and Structural Funds grants. More resources and focused technical assistance will help address this problem and necessary steps should be planned as soon as possible so that they can be taken in advance of the next Financial Perspective.
- The national, regional or municipal legislation as well as the administrative processes through which national, regional or municipal authorities must interact with each other on the one hand and with the Commission and applicable EU legislation on the other hand are not always clear, coordinated or complementary rather than supplementary. This is one of the main reasons for low levels of blended PPPs.
- The level, frequency and nature of communication with the private sector in respect of blended PPPs need to be further thought out, together with a clear message that the private sector is expected to contribute to solving issues and not only raising them. The engagement with the private sector should be of a sufficient depth and seriousness to induce confidence (level), regular so as to keep the dialogue interesting (frequency) and relevant to the problems encountered in practice so as to instigate interest.
- It would be beneficial to examine more closely the experience of the Member States in the application of national grant funding to PPPs, and how they have tackled the issues raised in this note (e.g. the cases of UK PFI credits, and German experience with PPP-grant blending).

Annex 1: Financial Engineering Instruments as a means of combining EU Funds and PPPs

A. JESSICA

1. Introduction

Addressing urban development challenges calls for large investments, adequate technical and managerial skills, which often are scarce in cities and towns. Against this backdrop in the programming period 2007 to 2013, the Commission in cooperation with the EIB and the Council of Europe Development Bank proposed a new initiative: JESSICA - Joint European Support for Sustainable Investment in City Areas. It is an optional financial instrument intended to address market failures (i.e. lack of investment funds to finance integrated urban renewal and regeneration projects) and facilitate accelerated investments in urban areas in the context of Cohesion Policy. JESSICA is not a new source of funding for Member States, but rather a new way of using existing Structural Funds grant allocations to support urban development projects.⁹ By complementing existing financing arrangements, it serves as a tool for financing projects regarding regeneration and development of urban areas and it is conducive to combining subsidies, loans and other financial products for this purpose. Also, it is a tool for stimulating private sector investment in integrated urban development through the use of market-driven instruments and as such is expected to leverage EU Structural Funds' contributions and mitigate some of the risks associated with complex urban development projects. Therefore, JESSICA is an instrument very well suited for investments in PPPs and its use addresses some of the issues encountered in particular in connection with revenue-generating PPP projects.

2. UDFs and Holding Funds

Funds that Managing Authorities (MAs) use for the JESSICA initiative can be certified as interim payments from their Structural Funds allocations, principally those supported by the ERDF but also, where appropriate, ESF, as investments rather than grants.¹⁰ This is done by placing funds from the Operational Programme (OP) into either an Urban Development Fund (UDF) directly or through a Holding Fund (HF), which then invests through UDFs. Where an UDF receives support from more than one Operational Programme, keeping separate accounting for contributions from each OP is necessary¹¹. An UDF can then provide non-grant financial instruments such as equity participations, loans, loan guarantees, subordinated loans and other risk-taking mechanism (including through PPP structures, etc.) therefore facilitating urban development investments.

UDFs may have different legal structures (from fully public to fully private, with all intermediary possibilities) and administrative forms. The UDF manager may decide the

⁹ EIB, *JESSICA: A New Way of Using EU Funding to Promote Sustainable Investments and Growth in Urban Areas*, 2007.

¹⁰ COCOF 08/0002/03-EN.

¹¹ COCOF 08/0002/01-EN.

exact legal structure or administrative form, provided that this is done with the observance of Regulation (EC) No 1828/2006 which stipulates that UDFs shall be set up as “independent legal entities governed by agreement between the co-financing partners or shareholders or as a separate block of finance within a financial institution”.

UDFs need not be geographically specific. Spatially-defined UDFs would invest exclusively within an urban area within a specific locality supported by an integrated urban plan, or in any other administrative space allowed by the Managing Authority. UDFs could alternatively cover the whole or part of the Managing Authority area, but specialise in sectors or have well-defined objectives. Sectors could vary from public-service investments (e.g. public transport, cultural and sports venues, etc.) to those targeting private buyers and operators, including housing, offices, commercial areas.

3. Eligibility of project expenditure

Rules on the eligibility of project expenditure, using JESSICA, are the same as those on the use of Structural Funds as a whole and also need to take account of any specific national constraints. Apart from specific non-eligible items listed in the relevant Regulations¹², JESSICA may allow for more flexible management of projects, respecting at the same time eligibility rules, provided always that the projects that are so supported form part of “integrated and sustainable” urban development plans¹³. Therefore, investments by UDFs in the commercial projects, such as shops, offices, entertainment, cultural and sport facilities, may be eligible for contributions from OPs co-financed by the ERDF, provided that such commercial projects: (a) are part of an integrated urban strategy as described in the Article 8 of the Regulation (EC) No 1080/2006, (b) comply with the Structural Funds legislation, and (c) comply with national eligibility rules within the meaning of the Article 56(4) of Regulation (EC) No 1083/2006 (this Regulation is sometimes referred to as the General Regulation).¹⁴ Concerning the specific provisions on the “integrated urban development”, it was explained by the Commission that the ERDF eligibility criteria for what can constitute an integrated urban development plan or project should be interpreted flexibly and be defined by Member States and Managing Authorities, taking account of the Article 8 of Regulation (EC) No 1080/2006 and the specific urban, administrative and legal context of each region¹⁵. It should also be noted that due to recent amendments to the EU Structural Funds regulations, projects related to energy efficiency and renewable energy in buildings do not necessarily have to be a part of an integrated plan for sustainable urban development. However, where an UDF supports, together with other projects, projects related to energy efficiency and use of renewable energy in buildings, such projects should be included in integrated plans for sustainable urban development. An integrated approach to urban project development is therefore encouraged.

¹² The most relevant legislative provisions include: Council Regulation (EC) No 1083/2006 of 11 July, 2006, laying down general provisions on the European Regional Development Fund, European Social Fund and the Cohesion Fund (the General Regulation); Regulation (EC) No 1080/2006 of the European Parliament and of the Council on the European Regional Development Fund of 5 July, 2006 and Commission Regulation (EC) No 1828/2006 of 8 December, 2006, setting out rules for the implementation of Council Regulation (EC) No 1083/2006 laying down general provisions on the European Regional Development Fund, the European Social Fund and the Cohesion Fund and of Regulation (EC) No 1080/2006 of the European Parliament and of the Council on the European Regional Development Fund.

¹³ EIB. JESSICA: A New Way of Using EU Funding to Promote Sustainable Investments and Growth in Urban Areas, 2007.

¹⁴ COCOF 08/0002/01-EN.

¹⁵ COCOF 08/0002/02-EN.

4. Distinctive features of Structural Funds financial engineering instruments

a. Recycling of funds through use of repayable instruments

The regulatory framework for JESSICA requires that contributions from Structural Funds be recycled¹⁶. Recycling of funding is expected to occur at the level of the Holding Fund and/or UDF. JESSICA funds must be invested in eligible project expenditure before the expiry date of the Structural Funds programming period (n+2, i.e. by the end of 2015). Any returns/receipts generated from that investment can be either retained by the UDFs or returned to Managing Authorities for reinvestment in new urban regeneration projects before or after the expiry of the n+2 or n+3 (as the case may be) period¹⁷. In addition it is recommended that returned resources be re-used in the region(s) covered by the Operational Programme and that re-use should be through financial engineering instruments, with a view to ensuring further leverage and recycling of public money¹⁸. As explained by the Commission, provision for the recycling of funds applies only to the amounts contributed by the MAs to the UDF and not to private co-financings¹⁹.

b. Non-application of paragraphs 1 to 5 of Article 55 of Regulation (EC) No 1083/2006 to financial engineering

Article 55 of Regulation (EC) no 1083/2006 which refers to revenue-generating projects raises a number of issues if the respective revenue-generating project is a PPP. Financial engineering instruments on the other hand are exempted from the application of paragraphs 1 to 5 of Article 55 of Regulation (EC) no 1083/2006. “[...] the very aim of financial engineering operations is to provide financial support through financial engineering instruments to enterprises and public-private partnerships (PPP) and urban development projects, and for such financial support to be repaid, with interest or with a gain, so that resources returned can be re-used for the benefit of enterprises, PPPs or projects. [] Thus, instead of applying the rationale in paragraphs 1 to 5 of Article 55 to financial engineering operations, which would have entailed a reduction in the financing given by the amount of any resulting interest or gain, the legislator has set out a specific regime for such operations which instead involves resources returned being re-used to finance other enterprises, PPPs or projects”²⁰. The main difference between the use of EU Funds under Article 55 of Regulation (EC) No 1083/2006 and the use of EU Funds *via* a financial engineering instrument is that while the profitability of financial engineering support is relevant to the decision to contribute that financial engineering instrument to an enterprise, PPP or project, it is not a determining factor when establishing the level of that contribution from the EU Funds, as is the case for projects subject to paragraphs 1 to 5 of Article 55 of the Regulation (EC) No 1083/2006.

¹⁶ Article 78(7) of Regulation (EC) No 1083/2006 expressly provides that "resources returned to the operation from investments undertaken by funds as defined in Article 44 or left over after all guarantees have been honoured shall be reused by the competent authorities of the Member State concerned for the benefit of urban development projects..."

¹⁷ EIB, *JESSICA: A New Way of Using EU Funding to Promote Sustainable Investments and Growth in Urban Areas*, 2007.

¹⁸ COCOF 08/0002/01-EN.

¹⁹ COCOF 08/0002/01-EN.

²⁰ COCOF 08/0002/01-EN.

c. Returns to EU Funds invested via a financial engineering instrument will not be subject to the n+2/n+3 rule

“It is for the parties to the funding agreements to determine the exact time when returns to the funds can be returned to the competent authority to be re-used for urban development projects. It would be reasonably expected that this would happen at the closure of the fund. In this way it could be ensured that during the entire period of the life of the fund finance is made available to PPPs and other urban development projects (or to enterprises, in the case of venture capital, loan or guarantee funds)”²¹. This feature presents the advantage of better leverage of EU Funds than other manners of combining EU Funds with PPP schemes.

d. Beneficiary

Beneficiaries of UDF financing (Final Recipients) must be eligible under the relevant Operational Programme from which the JESSICA funds are allocated. The beneficiary of an investment *via* a financial engineering instrument may be a financial investor or developer. While being an exception rather than the typical UDF structure it is also possible to have “A Special Purpose Vehicle set out to invest exclusively in a single project may be considered to be an “urban development fund set out to invest in public private partnerships and other urban projects”, provided it falls within the definition of an urban development fund in Article 44 of Regulation (EC) No 1083/2006, i.e., that it invests in PPPs or other projects included in an integrated plan for sustainable urban development, and that it does so in accordance with Regulation (EC) No 1828/2006”²².

²¹ COCOF 08/0002/01-EN.

²² COCOF 08/0002/01-EN.

B. Loan Guarantee for TEN-Transport (LGTT)

1. Introduction

The LGTT was set up and developed jointly by the EIB and the European Commission with the aim to attract a larger private sector participation in the financing of revenue-risk TEN-T projects. The instrument enables the transfer of demand risk inherent in a concession-based PPP project during the early years of operation thereby significantly improving the financial viability of the project and making the capital structure more robust. By providing the guarantee the EIB is taking over this risk by potentially becoming a mezzanine lender to the project. The flexibility of the LGTT structure permits a tailoring of the product to fit the needs of the project. The product also fits with state-guaranteed senior debt and is particularly suited to address the easing of refinancing in mini-perm structures.

The EIB and the EC have committed capital of EUR 500 million each to support LGTT operations of around EUR 5 billion until 2013. The EC contribution is made from the current TEN-T Budget while the EIB part is under the Structured Finance Facility (SFF) capital allocation. The SFF is the EIB's main facility for increased risk taking, established in order to support projects of European importance including large-scale infrastructure schemes. The LGTT was launched in 2008 and since then it was used in four PPP road projects that reached financial close with a total guarantee amount of EUR 140 million.

2. Level of financing provided by LGTT

The stand-by liquidity facility (SBF) guaranteed by the LGTT should not normally exceed 20 % of the total amount of the senior debt. The amount of the guarantee is subject to a maximum ceiling of €300 million per project pursuant to the SFF.

3. Risk reduction under the LGTT

Under the LGTT, the EIB will accept exposure to higher financial risks than under its normal lending activities. In effect, if the EIB guarantee is called upon by the SBF providers at the end of the availability period, then the EIB would reimburse the SBF providers and become a subordinated lender to the project but ahead of any payment to the equity providers and related financings. Once the EIB has become a creditor to the project, amounts due under the LGTT will also rank junior to the debt service of the senior credit facility. The EIB, by taking such subordinated risk through the LGTT guarantee, will help the project to cope with the revenue risk of the early years of operation while relying on the long-term perspective of the project to be financially viable.

4. Payments under the LGTT

The SBF can be drawn by the project company in case of unexpected reductions in traffic income of the project during the initial ramp-up period of operation in order to assure service of its senior credit facilities. The SBF, funded by commercial banks, will benefit from a guarantee from the EIB and will be available for draw down in the initial operating period only (up to 7 years after the construction of the project is completed). All repayments are to be made on the outstanding amounts of the SBF on a cash sweep basis and are subordinated to the senior loans underpinned by it. If at the end of the availability period there are still amounts outstanding under the SBF (accrued interest and principal), the LGTT guarantee can be called upon by the SBF providers, the EIB would pay out the SBF providers and then become subordinated creditor to the project. Once EIB becomes a creditor to the project, amounts due under the LGTT will rank junior to the debt service of the senior credit facility and would be repaid based on the availability of cash-flow post senior debt service, on a fixed amortisation schedule or on any other agreed reimbursement arrangement.

In order to reach a larger pool of candidate projects, the EIB and the EC consider that broadening the scope of the LGTT to availability-based schemes is worth examination. This would allow targeting significant investments in the rail and inland waterway projects which are in many cases being procured as availability-payments PPPs.

Annex II: Blending PPPs with TEN-T Grants and the grant application process

A. Introduction

The European Union is supporting the TEN-T implementation by several EU financial instruments and by loans from the European Investment Bank (EIB).

Grants, in particular under the TEN-T Programme and the Cohesion and European Development Funds, play a major role in both project preparation and implementation phases. Grants are allocated to studies (from feasibility studies to comprehensive technical or environmental studies and costly geological explorations), helping to overcome early stage project difficulties, and to the works phase. A key issue for the implementation of the TEN-T Programme is to link the efficient allocation of grants to the projects' European added value so as to ensure the best value for EU money.

In this context, the Trans-European Transport Network Executive Agency (TEN-T EA or the Agency) was created in 2006 to implement and manage the TEN-T programme on behalf of the Commission.

European Commission (DG MOVE): defines the policy	TEN-T EA: turns the policy into action
<ul style="list-style-type: none"> • Makes political decisions regarding the TEN-T programme • Defines strategy, objectives and priority areas of action • Takes the final financing decisions • Monitors and supervises the Agency 	<ul style="list-style-type: none"> • Implements the TEN-T programme on behalf of the European Commission and under its responsibility • Efficiently manages entire project lifecycle, including: <ul style="list-style-type: none"> ○ Organising calls and evaluations ○ Giving support to Member States • Prepares financing decisions • Provides key feedback to the European Commission

Two fundamental legal documents guide the allocation of EU financial support in the transport sector and provide information about the specific types of projects which are funded and in what amounts:

- **TEN-T Guidelines:** Decision N° 1692/96/EC of the European Parliament and of the Council of 23 July 1996 provides EU guidelines for the development of the trans-European transport network
- **TEN Regulation:** Regulation (EC) No 680/2007 of the European Parliament and of the Council of 20 June 2007 lays down general rules for the granting of EU financial aid in the field of the trans-European transport and energy networks.

The financial envelope for the implementation of the TEN-T Programme under the TEN Regulation for the period 2007-2013 is EUR 8.013 billion to support studies or works which contribute to the TEN-T programme objectives. The budget also includes EUR 500 million for the Loan Guarantee Instrument known as LGTT, an innovative financial instrument set up and developed jointly by the European Commission and the EIB which aims at facilitating a larger participation of the private sector in the financing of TEN-T infrastructure (please also see Annex I). Another EUR 80 million of the budget has been allocated to the Marguerite Fund²³.

The majority of the TEN-T funding is provided through grants. To allow this funding to ultimately improve the European transport network and increase mobility, there is a specific sequence of activities which need to take place in order to award it. These activities are summarised below.

B. Applying for grant funding

TEN-T funding opportunities are open to all EU Member States or, with the agreement of the Member States concerned, international organisations, joint undertakings, or public/private undertakings or bodies. TEN-T grants may be used to support studies or works which contribute to the TEN-T Programme objectives.

1. Calls for Proposals

The EUR 8 billion budget over the 2007-2013 funding period is primarily allocated to projects (which may be studies or works) selected via calls for proposals which are launched each year by DG MOVE and, as of 2009, by the TEN-T EA on its behalf. The norm is that, each year, a **Multi-Annual Call** and an **Annual Call** are launched.

Overall, the Multi-Annual Calls aim to give an important impetus to the implementation of the TEN-T priority projects - as defined in the TEN-T Guidelines - and to address some horizontal priorities.

Projects funded under the Multi-Annual Calls are expected to help complete the TEN-T network as approved by the European Parliament and the Council, with a target completion date of 2020. For this purpose, EU funding aims to mobilise as much public and private financing as needed to meet the challenging timetables. In general, Multi-Annual projects are of a larger size and longer duration than projects selected under Annual calls. 80-85% of the TEN-T budget is allocated through Multi-Annual Calls.

Annual Calls are intended to complement the Multi-Annual Calls, thus also giving priority to projects that address key TEN-T issues such as bottlenecks or cross-border projects. However, given their annual nature, Annual Calls have a higher degree of flexibility to meet new priorities.

²³ For more on the Marguerite Fund, please see <http://www.margueritefund.eu/>.

2. Evaluation and Selection

The Commission (DG MOVE), with the assistance of the Agency, carries out the evaluation and selection of submitted proposals. The process is supported by independent external experts, whose role is to ensure that only the highest quality proposals which best meet the award criteria as described in the relevant work programme and call text are selected for funding.

Proposals which meet the eligibility criteria specified for a call are evaluated on the basis of the criteria defined in the relevant work programme and call texts. Essentially, these relate to:

- relevance to the TEN-T priorities and policy objectives
- maturity
- impact - particularly on the environment and socio-economic considerations
- quality (completeness, clarity, soundness and coherence)

A list of proposals recommended for funding is then prepared by DG MOVE with the support of the Agency, taking into account the opinion of the external experts.

Successful applicants are then invited by the Agency to enter into negotiations on the basis of which, if agreement is reached, individual Commission Decisions are established to support individual projects.

3. The 2010 Annual Call under priority 3 targeting PPPs

The indicative available budget for this Annual Call was EUR 7 million and a possible EU contribution ranged from EUR 500,000 to EUR 2.5 million. The funds were intended for studies and thus the co-funding rate in respect of selected proposals was 50% of the total cost of the proposed studies. This Annual Call priority addressed two stages of maturity:

- studies (usually feasibility studies) in respect of projects that have suitable profiles for being implemented as PPPs
- studies that will allow a project in respect of which Value-for-Money has already been demonstrated to move closer to implementation.

4. Calls for individual projects: stages and responsibilities

	Stage	Description	Responsibility
1	Call publication	Calls define the following key terms of a project: indicative budget, general and specific objectives, results expected, eligibility criteria, selection criteria, award criteria, maximum possible rates of EU co-funding.	TEN-T EA
2	Info day		TEN-T EA
3	Submission of proposals		Applicants
4	Eligibility check	TEN-T EA checks the proposals submitted to it against the eligibility criteria specified in the call.	TEN-T EA
5	External evaluation	Conducted by external experts called upon by TEN-T EA. The Commission is not legally bound by the opinion of the external experts.	TEN-T EA, external experts
6	Internal evaluation (Selection)	Conducted by an Internal Evaluation Panel composed of representatives of DG MOVE, other DGs (if appropriate) and TEN-T EA. Reviews the reports prepared by external consultants and recommends proposals for funding.	TEN-T EA, DG MOVE, relevant DGs
7	Consultation of other DGs	The Evaluation Committee composed of DG MOVE Directors then assesses the list of projects suggested for funding by the Internal Evaluation Panel and prepares the final list of such projects for the Director-General of DG MOVE. The approved list is then submitted for consultation to other DGs (in particular DG-Environment and DG REGIO) to avoid double funding of projects under available EU funding programmes.	
8	Consultation of Financial Assistance Committee (FAC)	Following the approval by FAC and subject to a lack of opposition to the list by the European Parliament under its "right of scrutiny", a "framework Decision" is adopted, listing the proposals selected for funding and indicating the amount of funding to be awarded to each project.	TEN-T EA, FAC, European Parliament
9	European Parliament right of scrutiny		
10	Individual financing decisions	Applicants whose proposals are selected for funding are then invited to enter into negotiations with the TEN-T EA to finalise the terms of the grant Decision. Subject to their successful outcome, individual financing Decisions granting EU financial aid are then adopted for each selected project.	Commission

5. Distinctive features of combining TEN-T PPPs with EU Funds

PPPs imply the transfer of risks from the public to the private sector and whether the demand risk is being passed on or not is a major question in all PPPs. The current economic situation combined with the uncertainty around traffic forecasts (optimism bias) leads to a higher pricing of demand risk. Such demand risk might be too expensive to be fully, or to an appropriate extent, transferred in many proposed projects. Further, taking into account the inability to price the service to market and the uncertainty of the revenue stream, availability-based PPPs appear, at least in the short-to-medium term, a preferred solution for some TEN-T projects. It is in this type of transaction that combining EU Funds with PPPs can have the greatest contribution to reducing the cost of private capital. Although TEN-T beneficiaries can be private companies, the use of TEN-T grants to support the construction (works) component of a PPP has been very limited. Most TEN-T grants supporting PPPs have focussed on studies in the project preparation phase. The following issues have been identified as obstacles in utilising grants for works in PPPs:

- **Low leverage of EU Funds:** the maximum co-funding rate for works is 30% for cross-border projects, the rate for a project in a single Member State is 10%.
- **Confidentiality:** the EU Funds are paid against receipts for the construction costs (ex-post) and may put the confidentiality of a PPP contract at risk. The availability payment comprises amounts for the recovery of construction costs, financing costs as well as current and future maintenance and operating expenses, but only construction costs are eligible. The proportionate amounts of the availability payment are proprietary. The level of disclosure required in order to receive the grant disbursement for the construction works component of the blended payment impinges upon the principles of confidentiality.
- **Timing:** Article 12.4 of the current TEN Regulation, provides that “in the case of availability payment schemes, the first prefinancing payment shall be made within a period of up to three years following the granting of Community financial aid” and Article 13.1.a. of the current TEN Regulation provides that projects which have not been started in the two years following the start date of the project may be subject to penalties, including cancellation of the grant. On the other hand, if the grant is awarded before construction starts so that it produces a maximum leverage effect on the PPP financing, then complying with the 3-year rule becomes very difficult. Furthermore, funding meant to support an availability payment PPP project should not be limited by the 7-year duration of an EU budgetary cycle, as is currently the case.

Annex III: Blending PPPs with Structural Funds grants - the funding gap and the timing of the grant application²⁴

A. Conditions for a PPP to become a blended project

- It must fulfil the EU funding criteria (be in line with the requirements of a particular priority axis under an Operational Programme).
- It has to be attractive for a private investor potentially interested in a PPP project, either as a stand-alone project or grouped with similar projects.
- It has to have a proper timeline allowing implementation during one financial perspective, so that the procurement, negotiations and construction would fit into one programming period. Large PPP projects take a lot of time to implement, and if they are to be co-financed with EU Funds (and hence require approval of the Commission, which is also time consuming) – they should be prepared early in the relevant budgetary period. It is recommended to analyse how the additional time necessary to obtain EU Funds will impact the overall timeline of the PPP project. Are the advantages of such a method of financing higher than the disadvantages and the value of lost time? Those questions have to be answered separately for each project, taking into account financial, economic and social costs and benefits.
- It cannot be too advanced. There are several rules relating to EU Funds (e.g. procurement requirements, project promotion requirements) that must be complied with, in order to receive the EU Funds. The risk of procedural problems should be mitigated to assure the payment of funds.
- A financial analysis and a CBA supplemented by a quantitative risk analysis (public sector comparator / Value for Money analysis) have to support this form of financing as the best solution for the project. One should bear in mind that a feasibility study, CBA and environmental assessment are necessary for EU co-financing, while a public sector comparator / Value for Money analysis forms the basis for a decision on whether to carry out the project as PPP; the Value for Money analysis should take into consideration the blended PPP option if there is a possibility of obtaining EU Funds for the project.
- The project can take advantage of existing policy commitment to public sector efficiency through private sector involvement for services and/or a major investment program requiring grant support to achieve affordability.
- In the case of revenue-generating projects, these projects have inherently a lower level of grant funding but are not inherently less suitable for blending, although even with EU grant funding they will still require some national grant contribution to the funding gap.

²⁴ This section draws heavily on documentation produced by JASPERS as well as on conversations and other communications with JASPERS specialists.

B. The level of the EU grant is determined by the level of eligible expenditures

The eligible expenditure is the key basis for the calculation of the level of Community assistance. This calculation depends on the type of project:

For non-revenue generating projects:

The level of grant is calculated by applying the co-financing rate to the total of eligible costs²⁵.

For revenue generating projects:

The funding-gap²⁶ method will be applied.

C. The funding gap: concept and application

The funding gap rules work the same for all revenue-generating infrastructure projects, whether PPP or not, because they relate to revenue generation and not the financing structure of the project²⁷. Therefore in principle there should be no difference in the grant rate for a project funded under a PPP or a different structure – the EU and national grant funding would need to make up for the whole funding gap – which is essentially driven by an affordability constraint.

The funding gap in a revenue generating project is a key determinant of the amount of grant finance that will be available to a project. The calculation consists of applying the co-financing rate to the part of investment costs that are not covered by the user charge revenues generated by the project. The expenditure eligible for grant finance is calculated as the investment cost minus the discounted net revenue generated by the project and the residual value of the assets. This constitutes the funding gap. The co-financing rate of the operational programme is then applied to the funding gap. If the expected user charge revenue is found to be higher than the investment costs and the operating costs, the project is not eligible for EU funding. The EU grant can only fund a project up to the point at which its grant funding, combined with national grant co-financing, enables profitability and sustainability to be achieved.

In revenue generating projects which have user charges as the only source of revenue, and which may be structured as a PPP, the private sector would only be willing to fund investment up to the amount matched by the discounted net revenue stream – e.g. by using loan or equity funding with the expectation of repayment, with suitable return, from the net revenues of the project. Therefore any private funding may be considered to be “matched” against the net revenue generated by the project, and not part of the funding gap. However, the level of future revenues is subject to risks (demand) and policy (tariffs, alternatives); both of these risks have to be addressed as part of the PPP structure.

²⁵ The co-financing rate, defined as the percentage of total eligible costs that can be co-financed by the EU grant, is set by priority axis in every operational programme.

²⁶ The funding-gap method is defined in article 55 of the General Regulation. It is also clearly explained in the Commission Working Document No.4 “Guidance on the methodology for carrying out Cost-Benefit analysis” and in COCOF 07/0074/04-EN. Further guidance is available in JASPERS’s Working paper “Combining EU Grant Funding with PPP for Infrastructure: Conceptual Models and Case Examples”.

²⁷ More detailed information on funding gap is available in “Guide to Cost Benefits Analysis of Investment Projects”, document prepared for Evaluation Unit DG Regional Policy European Commission.

The private partner will not be interested in financing the capital and operational expenditures over and above those backed by the user charge revenue without being assured of a return on their investment. This means that the funding gap between the funds the private partner is willing to commit to the project and the total financing demand has to be filled by public funds, with EU grant funding being one of the options. The public financing can be structured in several different ways, including participation in capital expenditures, shadow tolls, or availability payments to the private partner.

Availability charges would not be considered as “revenues” for the purpose of Article 55²⁸ and therefore in such projects the level of co-financing is not dependent on the existence or not of the funding gap. The availability payments (unlike say toll revenue) would enable the project to support public co-financing of eligible costs and so would not result in lower grant rates due to the nature of the revenue stream.

Additionally, Article 55 provides for the possibility of claw-back in the case of revenues higher than forecasted due to changes in the tariff regime (though not from macro-economic changes or trends not forecast at the time of project preparation).

D. Timing: when to apply for a grant?

In general the PPP process would need to be well defined and described in the grant application, so that its main features are taken into account in the grant approval process²⁹. Equally important, the grant approval process needs also to be well described in the PPP tender documentation, to give comfort to bidders that the EU grant funding will indeed materialise, and at the right time.

Grant application can be submitted either before commercial close or after commercial close³⁰.

1. The grant application is submitted before commercial close

In this case, the grant applicant must be able to provide to the Commission the results of feasibility studies including financial and economic analysis (this is a mandatory requirement in the case of major projects³¹). The financial analysis determines the appropriate level of contribution from the EU Funds³², besides evaluating the financial profitability of the investment and the financial sustainability of the project.

²⁸ As confirmed in the COCOF Note 07/0029/01-EN.

²⁹ According Council Regulation (EC) No 1083/2006, Article 40, the grant application should include inter alia: information on the body responsible for the implementation of the project; description of the investment including the estimation of its financial volume; estimation of the amount to be co-financed by the EU Funds.

³⁰ By commercial close we understand the award of the contract to the preferred bidder. It means that the identity of the PPP company is fully known after commercial close.

³¹ Council Regulation (EC) No 1083/2006, Article 40 (c) and (e).

³² Working Document No.4 of the Commission, “Guidance on the methodology for carrying out Cost-Benefit analysis”, p.7

There are **two main advantages** to submitting the grant application before commercial close:

- The entire process is shortened because it is not necessary to wait for the award of the PPP contract to submit the grant application; and
- The private sector is able to take the EU grant into account in its proposal.

There is **also a drawback**:

The Commission awards the grant at the level resulting from the Cost-Benefit analysis. There is a risk, once the call for tenders has been launched, that the received bids are much higher (or much lower, making the EU Funds over-financing the project) than what was estimated in the feasibility studies and in the Cost-Benefit analysis. Therefore, the real need for co-financing will be superior or lower to the actual EU grant. If such a situation occurs, the application may need to be re-submitted taking into account either one of these realities (although it is noted that the same situation may arise in case of traditional projects, where the funding gap post-procurement may be considerably reduced or increased in case contracted investment cost differs substantially from that estimated during the feasibility stage).

One way of avoiding the risk described in the paragraph immediately above is for the grant applicant to regularly communicate with both the Commission and the national authorities from the earliest stage of a project. In addition, this risk could be avoided if, in the tender documents, the award criterion of the PPP is not lowest price but rather something independent of the level of grant (such as amount of additional capex, or duration of the contract, for instance).

The Commission has a legal obligation to decide on the grant approval within three months from the day of submission³³.

It is important to note that the three months period assumes that the grant application contains all relevant information needed for approving the project. If this is not the case, the application review process may be interrupted by DG REGIO while further information is requested from the grant applicant. In order to reduce the risk of such interruptions it is especially important to have a clear presentation of the PPP preparation and tendering process, as this could be one area in which DG REGIO might request additional information.

The Directive 2004/18 on Public Procurement sets the minimum delays between the tender publication and the receipt of proposals at 40 days from the day the tender was published in case of a restricted procedure. In the case of a competitive dialogue the delay is 37 days. The grant applicant should bear in mind that those are minimums. The complexity of infrastructure projects will most likely require longer delays.

For submission of expressions of interest to be short listed

Restricted procedure, competitive dialogue and negotiated procedure with notice – 37 days minimum

For submission of tenders

Restricted procedure – 40 days minimum

Competitive dialogue and negotiated procedure with notice – not specified

³³ Council Regulation (EC) No 1083/2006, Article 41.

2. The grant application is submitted after commercial close

This will be the case mainly when the feasibility studies are not detailed enough and the level of information is insufficient for introducing an application, or when the results of the bids, potentially in the case of a competitive dialogue procedure, could substantially influence the financial figures of the project. It could also apply if the grant applicant wishes to reduce the risk of having to re-submit an application due to changes in project cost and grant rate resulting from the tender process.

There is a risk that the grant might not be approved after the commercial close, although this risk might be lower if the project is already listed as an indicative major project in the Operational Programme. As a practical and operational solution to mitigate this risk, the grant applicant should always communicate with the Managing Authority and request it to review the tender dossier before it is published. After review, the grant application is finally submitted to the Commission. Such communication could also be established at Commission level, although it should be noted that the Commission is more involved at Operational Programme level than at project level. JASPERS, whose role is to assist certain Member States in the preparation of this type of projects, should also be a valuable interlocutor.

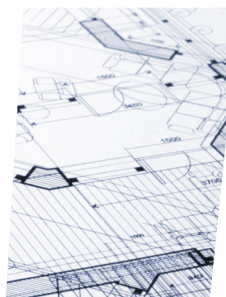
By the time that a preferred bidder is selected, the Contracting Authority should finalise the grant application. The following steps should be taken in chronological order:

- a) Close the commercial phase.
- b) Include all the relevant information on the contract in the grant application.
- c) Submit the grant application.

As mentioned previously, the Commission has the obligation to communicate its decision within a maximum of three months from the day the grant application is submitted, provided that the application is clear and the application process does not need to be interrupted to obtain further information.

The table below summarises the respective advantages and drawbacks of each of the two scenarios described above, taking into account that in each case careful time management is crucial:




	Advantages	Drawbacks	Type of projects where preferable
Scenario 1: grant application before commercial close	<ul style="list-style-type: none"> • Reduces the delays of grant award • The private sector can fully integrate the EU grant into its proposal 	<ul style="list-style-type: none"> • Risk of bids being higher/lower than estimated and therefore level of grant is inaccurate 	<ul style="list-style-type: none"> • High quality of feasibility studies
Scenario 2: grant application after commercial close	<ul style="list-style-type: none"> • Allows to provide full information on the PPP contract in the grant application • Reduces uncertainty on award of grant 	<ul style="list-style-type: none"> • Extends the overall length of the procedure 	<ul style="list-style-type: none"> • When bids could substantially influence the financial figures of the project (competitive dialogue)





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