



CORPORATE FINANCE

Dutch Ministry of Finance

ADVISORY

The impact of TENs co-financing and
subsidy conditions on projects, and
proposals for reform

KPMG LLP
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1 Foreword by Dr. Timothy J. Stone



This report looks at an important policy area for the European Union - the TENs programme which supports major transport infrastructure projects and promotes socio-economic development and cohesion within EU Member States. Over €600 million is spent each year. Yet there is concern over how effective the grant is, and how well it fits with modern financing techniques that promote Public Private Partnerships (PPPs).

Member States are keen to ensure that EU grant monies are being spent efficiently and effectively. The reforms proposed in this report, if properly implemented, will contribute towards the achievement of this goal.

We have studied the current TENs grant arrangements, including proposals already under discussion, and developed ten ideas for reform as listed below. These have been tested with KPMG colleagues across Europe, the Commission as well as the EU Informal PPP Group. We have also developed a note setting out the reasons why governments should consider moving away from an approach to project appraisal which focuses on construction costs, to one that takes account of project life-cycle costs. The guiding principles that should underpin any methodology to achieve this shift in thinking are also considered.

The ten ideas that we have set out for improving the TENs programme are summarised below:

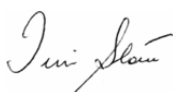
- 1: Undertake full life-cycle appraisal of projects
- 2: Conduct reviews at 'check points' during the project life-cycle
- 3: Introduce funding competitions with higher intervention rates for winners
- 4: Consider setting up a Fund to spread payments or
- 5: Consider giving Member States the flexibility to spread payments
- 6: Develop pathfinders projects to test new ideas
- 7: Use TENs funding to support guarantee facilities
- 8: Encourage capacity building to stimulate the development of good projects
- 9: Establish an Executive Agency to co-ordinate TENs projects
- 10: Establish an EU PPP Knowledge Centre

Although some of these ideas are provocative, and may be hard to implement quickly, it is important to engage all relevant stakeholders in debating these proposals so as to achieve some 'quick wins'. The Karel Van Miert High Level Group, in its report published on 30 June 2003, initiated an important debate and made some recommendations (which have been accepted by the Commission) on how to move the TENs programme forward. This report represents KPMG's contribution to this debate.

It is worth noting however that the ideas contained in this report do not represent a proposal for a more interventionist role for the Commission; this is for the policy makers to decide. The principles that underlie our thinking would remain the same whether the implementation was through a more interventionist Commission, or through greater delegation to the Member States.

Three ideas – full life appraisal, reviews at check points and capacity building – could be taken forward swiftly by the Commission. Such action could make a considerable difference to the effectiveness of the TENs grant, and the underlying quality of the projects, in the next budgetary perspective (2007-2013).

I am grateful to the Dutch Ministry of Finance for commissioning this short study.



Chairman
Financing Group
KPMG LLP

1 Introduction

The Dutch Ministry of Finance asked KPMG LLP in October 2004 to prepare two concise notes:

- The first to examine the impact of the TENs co-financing and subsidy conditions on traditionally procured projects as well as PPPs, and in particular the current limitations on long-term funding commitment, and to make recommendations on how these can be addressed
- The second a policy document aimed at helping promote a shift in thinking within the Commission and Member States, from a focus on construction costs to that of operating and life-cycle costs. This note provides policy proposals designed to promote whole-life cost appraisal and offer a methodology for building a life-cycle comparator

We were asked to work closely with the Commission, principally DG Tren, to prepare the notes. During the course of our review, we held a workshop at the Commission, conducted a number of telephone interviews and made a presentation to the Informal PPP Group. We have also consulted colleagues in KPMG countries across the EU on our emerging views.

This report contains a brief review of the current situation and our analysis of the problems of the current grant conditions. It then examines a series of ideas for reforming the TENs grants.

This was a short study of a complex area, with substantial existing documentation. Consequently it can only touch very briefly on some complex and important areas such as the relationship with the other EU funds or the role of the EIB. We have also said very little about other important areas of EU policy as they affect PPPs, for example the public procurement rules. In putting forward proposals for change we have tried to be practical, but not too bound by existing rules and procedures and by the difficulties of getting Council and Parliament approval to changes in regulations. Consequently, further development work would be needed before some of our proposals could be implemented.

Section 2 sets out the current position and the issues this raises. It includes a discussion of the changes currently being proposed, and a look at the relationship between TENs and the EIB, and between TENs and the Cohesion and Regional funds.

Section 3 then looks at the problem presented to us and the ideas that we think might form part of a policy solution.

Section 4 summarises our conclusions and considers implementation.

Annex A contains the Commission and EIB's proposed criteria for selecting projects to qualify for intervention rates above 10% of construction costs.

The end notes contain references and some supplementary material.

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NOTE 1

Proposed Reforms to the TENs Programme

2 Current position

2.1 The challenge for TENs

There is a huge requirement for transport infrastructure projects in the EU. The need for transport projects has been estimated at up to €600 billion between now and 2020ⁱ. Almost all Member States face difficulties in funding large transport infrastructure projects out of their budgets. Consequently such projects are vulnerable to postponement or occasionally cancellation. Projects that cross borders or provide a channel for international traffic are sometimes difficult to justify simply in terms of the benefits to a single Member State.

Within the €600 billion total, the European Parliament and the Council established a list of 30 priority projects with an estimated capital cost of €225 billion up to 2020 (Decision 884/2004/EC). However, the current funding for TENs is only around €600 million a year.

2.2 The current grant conditions and procedures

The TENs arrangements up to the changes in 2004 had the following features:

- Grant was payable at up to 10% of construction cost
- Grant could normally only be paid against construction costs, and not for maintenance costs
- There were, however, grants paid for up to 50% of study costs, but these counted against the overall 10% limit
- Projects were submitted by the Member States
- The process within the Commission was essentially administrative, rather than focussed on the merits of the project. Very limited specialist project resources were available to the Commission
- Grant was paid as a capital sum, normally in tranches as capital expenditure was incurred but with some delay
- The EU funding was time limited to the seven year financial perspective, with a two year period beyond when payments could be applied against spending on previously agreed projects
- The n+2 timing limitation means that a grant could be revoked if the project did not start a maximum of two years after approval.
- Once the EU had approved a project for funding, there was very little monitoring of its progress, other than administrative checks for payment purposes

During our review we discussed a number of problems that had been observed with the TENs programme.

The first is poor project performance. Transport projects have a tendency to have capital cost overruns, to open late and to have lower than expected traffic levels. There is no specific evidence on TENs, but international studies in the rail and road sectors show a standard tendency for transport schemes to have higher than budgeted capital costs and lower than expected forecast revenuesⁱⁱ. The reasons for this systemic bias towards optimism have been discussed in various reports; and explanations include poor project planning and deliberate game playing in circumstances where national governments are often expected to pick up any financial shortfall. Having said that, the TENs grant features do not seem to be encouraging improvements in project performance. The restricted project appraisal undertaken by DG Tren and the lack of specialist staff mean that there is limited 'challenge' at Commission level.

The second is poor 'additionality' – i.e. the extent to which the TENs grant leads to a change in the number and timing of projects delivered. To gain maximum leverage, TENs grants should be paid at the level that supports the largest amount of efficient project expenditure which would not otherwise have occurred. By contrast, it appears as if the decision by Member States to support a project is decided independently of whether or not TENs funding is available. Consequently, rather than being an enabler, the TENs funding becomes a bonus for the national government. Here the low level of the grant and the limited selection at Commission level appear to be contributing factors.

A further reported problem is poor coordination on international projects. A high speed rail line often requires at least two countries to cooperate over route and timing. A delay by one Member State will seriously affect the overall benefits from the scheme.

The final problem is a poor fit with financing techniques that promote private sector involvement. Some Member States, including the Netherlands, the UK, Ireland, Portugal and others have responded to poor performance of past transport projects by using PPPs. These have a number of advantages:

- They encourage appraisal of the 'whole life costs' of the project and effectively force greater accountability for the overall project and original decision
- The transfer of risks at a fixed price to the private sector brings out more realistic cost and, sometimes, revenue estimates. Over optimism is brought to the surface earlier; there is also an improvement in the quality of the risk allocation process and a reduced tendency by the private sector to accept risks that they know can be passed back to the public sector under traditional change mechanisms
- The contractual structures used require project promoters to be clear about objectives and requirements. On the other hand, they make late changes, for instance during construction, difficult

Payments under PPPs tend to be based on (service) outputs, rather than inputs, often for the availability of the infrastructure. Alternatively, there may be government subsidies to support inadequate revenues on projects involving direct user charging, such as road tolls or rail fares. As a result, in many cases, the public sector contribution has to be spread across the operational life of a project, rather than restricted to the construction period, in a way that properly promotes sustainable delivery of the required service.

Supporting service-related payments would require commitment for 25 to 30 years across a number of financial perspectives. This gives a poor fit with the way that investment grants such as TENs are currently paid. At present, the public sector often has to commit itself contractually before there is certainty that TENs grant will be paid but this is not a risk that can be transferred to the private sector. Consequently, the TENs payments do not always lever in additional monies from the public sector, resulting in substitution of public funding commitment with TENs funding, rather than more public sector money (above the minimum required for co-financing) in addition to the agreed TENs allocation. The rigidity in the way TENs funding is applied encourages Member States to maintain separate lists of PPP and potential TENs projects.

The other difficulty in the current TENs arrangements is the effect of the time limitation. At present TENs monies need to be applied for and disbursed within the six or seven year financial perspective plus the two additional years. From the key decision by government to proceed, a typical PPP rail project in Europe will have a pre-construction period of around two years, after the key decision to proceed, plus a three to five year construction period. So the advice to the public sector, from a firm such as KPMG, on financial planning and structuring will be given about seven to eight years before the project opens. This suggests that only in the first couple of years in any budget perspective can a project realistically expect to receive its full grant potential. Any later, and the project, whether a PPP or not, faces an uncertain grant position. While this 'grant risk' can in the early years of the project be taken by the public sector, in order for the project to proceed; it then leads to poor 'additionality' as discussed above.

A further complication on the timing issue is the n+2 rule – a grant can be revoked if the project has not commenced two years following the date on which the grant was approved. This rule works against PPPs for the reasons already discussed above.

2.3 Changes already proposed

There are a number of changes to the TENs arrangements that have either been decided on, or are currently under discussion. These will mainly impact on TENs decisions in the financial perspective starting 2007, as the funding for the remainder of the current perspective is already committed. They include:

- Decision 807/2004/EC, adopted this year, allows for a grant rate of up to 20% in exceptional cases, for added value projects, particularly of cross-border or international significance
- In addition, grants used to support study costs will not now count against the funding limit
- A further increase in the grant rate to 50% of construction costs has been proposed by the Commission

- Article 17a of decision 807/2004/EC also provides for the appointment of a European Co-ordinator. This role is seen as a project specific one, with a senior person of political standing coordinating a major cross border link
- Some discussion has taken place around an Executive Agency, to be established by DG Tren, to administer the TENs budget and undertake project appraisal if there is an increased budget in the next financial perspective
- The recent announcement of a proposed EU loan guarantee facility, aimed at providing short-term credit enhancement during the immediate post-construction (ramp-up phase) for projects with significant revenue risk.
- Since accession to the EU in May, the TENs programme now applies to a larger group of Member States, 25 rather than 15

These changes are important, though the details in some cases are still being worked out. In particular both the Commission and the EIB have considered which projects should receive grant at a higher rate than 10%, and under which conditions. The criteria in the regulation, and the Commission's proposals on project applications and the EIB's proposals are included in Annex A. The criteria in the regulation, though specific, are wide. The proposals in the Commission's and the EIB's papers cover the idea of a fuller application for grant, and the assessment of applications against economic and financial criteria, grant additionality, and an international or European element in the project.

The work done so far has, however, two gaps. It does not spell out how the new procedures and appraisal will work in practice. In addition, the payment and budgetary timing issues remain. These topics were at the heart of our work.

We also considered the political and administrative climate in which our ideas will be considered. There is considerable debate as to how interventionist the Commission should be, and how much it should trust the Member States under the subsidiarity philosophy. Many Member States are cautious about greater interference in their projects and of new Commission institutions.

2.4 Other project issues

We have already noted that many of the problems of TENs projects are endemic within the transport sector in Europe and worldwide. It is also important to comment that TENs is not the only barrier to adopting different approaches to projects, including PPPs, in many countries. In some countries especially in the EU 10 there is a shortage of projects, not generally because of a lack of need, but more because of a shortage of resources to develop projects. The project finance market may be underdeveloped and the government may not have the necessary administrative skills or may have poor relations with the private sector market. Finally, PPP is not a way of avoiding payment for capital projects, and government finances need to be strong enough to meet its obligations, whether through availability-related payments or subsidies to reduce the level of tolls or other direct user charges. This point is of a particular importance for project funders because there is a marked reluctance to support projects where the government's willingness to pay (as opposed to ability to pay) may decline over time due to a combination of budgetary pressures and changing political priorities. Amendments to the TENs rules can assist change, but may not be sufficient on their own.

2.5 Role of the EIB

The Council has called on the EIB to play a more prominent role in bringing TENs projects to fruition. To this end, the EIB and the Commission have developed a number of key instruments. These includeⁱⁱⁱ:

- TENs Investment Facility (TIF): a commitment to lend €50 billion in support of the TENs priority projects
- Structured Finance Facility (SFF): this is designed to give the EIB capacity to increase the availability of debt finance during the early phases of projects. This facility has an overall reserve allocation of €500 million
- EU Loan Guarantee Instrument: the EIB has been assisting the Commission in its design and market testing of this proposed instrument to be introduced in the 2007-2013 financial perspective. The Commission is still consulting on the details but the aim is to encourage lending to projects with

passenger or toll revenue. The Commission would guarantee debt repayment during the high risk 'ramp-up' period immediately post-construction. This said, no final decision has been taken on whether this product would be offered through the EIB

- TENs Infrastructure Risk Capital Scheme: a facility funded by the Commission to stimulate the access of TENs projects to risk capital. This is done through co-investing with the private sector in infrastructure investment funds with a priority focus on providing risk capital for TENs projects.

As required by the European Growth Initiative (December 2003), the EIB is working on a range of other financial instruments to encourage private sector participation in the provision of public infrastructure.

2.6 Structural and Cohesion Funds

Both TENs and Cohesion fund grants can be used to support transport projects in eligible Member States. However, since the TENs intervention rate at 20% (until recently 10%) is significantly lower than the 85% available from the Cohesion fund, there is a tendency for project sponsors in 'cohesion states' to apply for TENs funding to support feasibility studies and Cohesion funding to support construction costs.

This is not necessarily a problem because the bulk of the TENs funding (85%) until 2006 has been earmarked for the EU 15 countries. From 2007, the EU 10 countries will receive a significant boost to their share of the TENs budget.

There is an important point here. The high rates, and relatively high budget, for Structural and Cohesion funds deter the development of PPP. Equally the low rate, and relatively low budget, for TENs means that it has a limited effect on what is delivered. In abstract, would appear that a grant with a rate in the middle would have the maximum effect in stimulating projects.

Under current proposals^{iv}, the rules governing the Structural and Cohesion funds are being brought closer together. The revised rules, which are likely to represent a significant departure from current practice, will be introduced during the 2007-2013 financial perspective. This will mean further devolution of responsibility to Member States with DG Regio taking more of a back seat. A programme approach is being introduced in preference to a project-based approach and, in line with the wishes of Member States, once the grant has been approved and paid, the Commission will have no further involvement in deciding how the money is spent. This is an example of a move away from interventionism.

Consequently, the management of TENs and Cohesion budgets are likely to move in opposite directions. The recommendations presented in the rest of this report could suggest a more hands-on interventionist role for DG Tren in managing the TENS budget. By contrast DG Regio's role is likely to be reduced. For this reason, some of our key recommendations may not be applicable to the Cohesion and Structural funds if applied at Commission level. We have tried to show, however, that many of them could be applied at Member State level, i.e. at the Cohesion and Structural funds application level, and this may represent a way forward for TENs co-financing with those budgets over the coming years.

2.7 Analysis

The next section develops this thinking into a structured framework. This framework takes the discussion above, the work already in hand and the wider problems and looks at it in four topics. The points about TENs projects and TENs grant leverage are broken up into topics on:

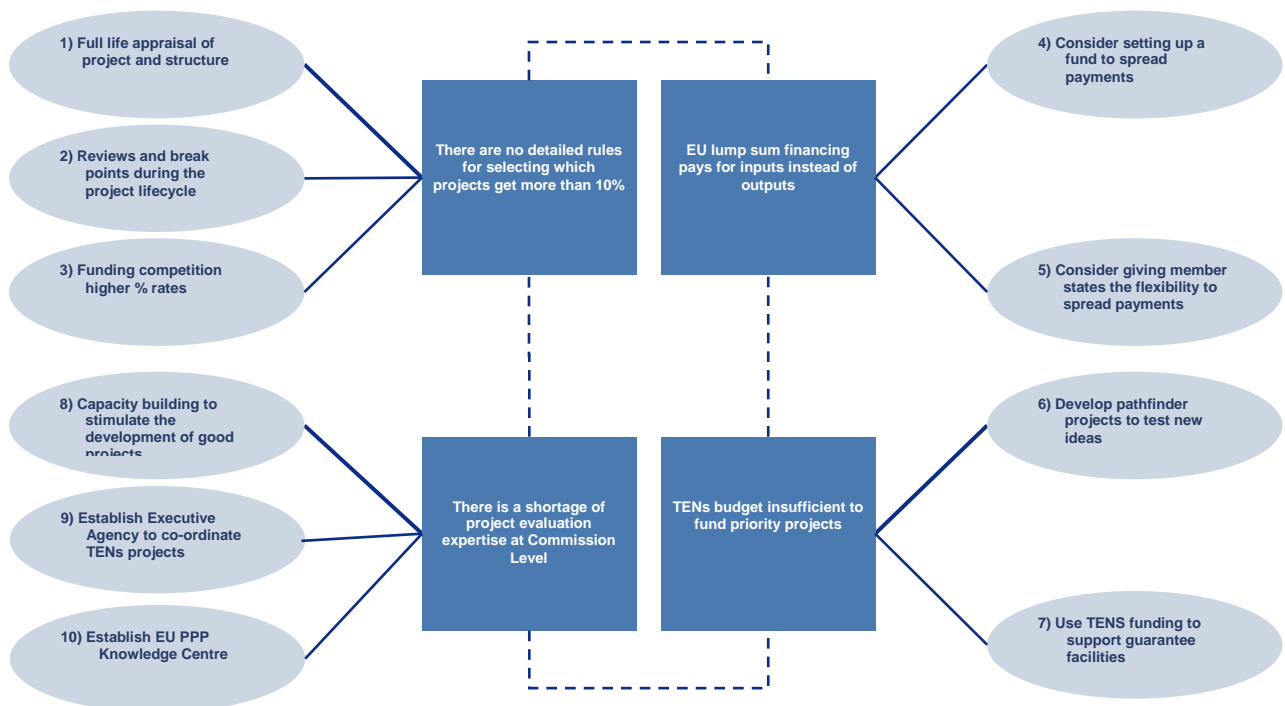
- first, changing the grant procedures and setting detailed rules for a higher grant rate
- secondly, building expertise at Commission level
- and thirdly, making the best use of the available budget.

The points about PPPs are covered under the topic dealing with inputs and outputs.

3 Problems and proposals

The graphic below shows the approach we have adopted. We saw the overall objectives as being: bringing forward transport infrastructure projects, leveraging the maximum out of a limited TENs budget and providing a good fit with modern project finance structures. Within this, we have divided our work into four main topics: setting the rules for the new intervention rate; resolving the payment timing issues; getting the most out of the budget; and developing the knowledge base. For each topic, we have written a brief description of the 'problem' and then generated a number of ideas. These were discussed at a workshop with the Dutch Ministry of Finance and the Commission. Subsequent to the workshop we have refined our ideas as presented below.

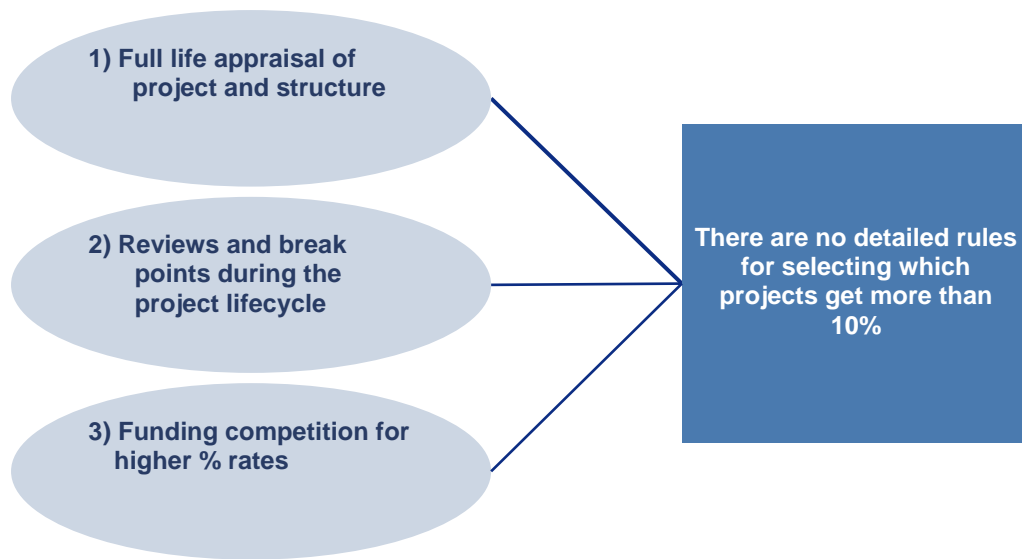
The topics inevitably overlap, and the ideas will need to be linked together to form an overall solution. Many of the ideas draw on work previously undertaken by others.



3.1 Setting detailed rules for a changed intervention rate

3.1.1 Problem: There are no detailed rules for selecting which projects get more than 10%

The Commission has recently put forward a proposal for an intervention rate of up to 50%. Although this is yet to be agreed, there is now a legal basis, in the case cross border projects, for paying grants of up to 20%. Devising detailed methodology for selecting those projects properly is a current problem, and the guidelines in decision 807/2004/EC and subsequent DG Tren and EIB papers^v require further development. Specifying the right selection criteria is important as it provides a way of incentivising the development of better projects. The Commission's interpretation of current provisions, is that the choice is between two grant rates – 10% or 20%, thus avoiding the need for a complex formula to determine which rate between 10% and 20% should apply. Although a simple division of the projects into one category or the other will suffice for now, this is likely to change in the longer term, especially if the Commission's proposal for a higher rate is adopted. Hence the need for detailed methodology to determine which projects qualify for the higher grant rate.



3.1.2 Idea 1: Full life appraisal of project and structure

Our first idea is that only projects with an appraisal that takes account of long-term costs and benefits should be considered for the higher level of grant. Such an appraisal should examine operations and maintenance costs through the project life, and consider different project structures. Project appraisals of this kind already take place in many Member States such as Netherlands, UK, Ireland and Portugal; however, such practice needs to be more widespread.

A suggested explanation of how this long-term lifecycle analysis should be undertaken is provided in more detail under Note 2 of this report.

Proper appraisal can include environmental and social factors, as well as financial and economic ones. It should look at risks, but should not presume any particular project structure. The right project structure can differ by country and project type.

Some Member States may need time to adapt to this idea, and this may affect the timescale for implementation. However, it is hard to see how the Commission can influence the quality of projects without encouraging countries to undertake detailed project appraisals. Projects need appraisal even if they are large or complex or on an international route – or all three. Proper appraisal supports political decisions on which projects should proceed, but not a substitute for them. Although appraisal is essential for both 10% and 20% projects, this proposal suggest that the level of detail required for the latter should be greater.

This idea does not need to lead to greater Commission intervention in all cases. Note 2 sets out some principles. Where these are met by existing appraisals techniques, within the rules of a particular Member State, no further work would be needed.

3.1.3 Idea 2: Reviews and break points during the project lifecycle

Our next idea is that the EU should not simply approve projects once. Projects which have a 20% grant rate should subject themselves to Check Point Reviews (CPRs) by the Commission at various stages. If there has been significant change in the project, then the EU should have the right to review the commitment to grant funding. The conditions for this would need careful thought.

The idea of CPRs is similar to the Gateway Review process already undertaken for many projects in the UK. The benefits of this approach are:

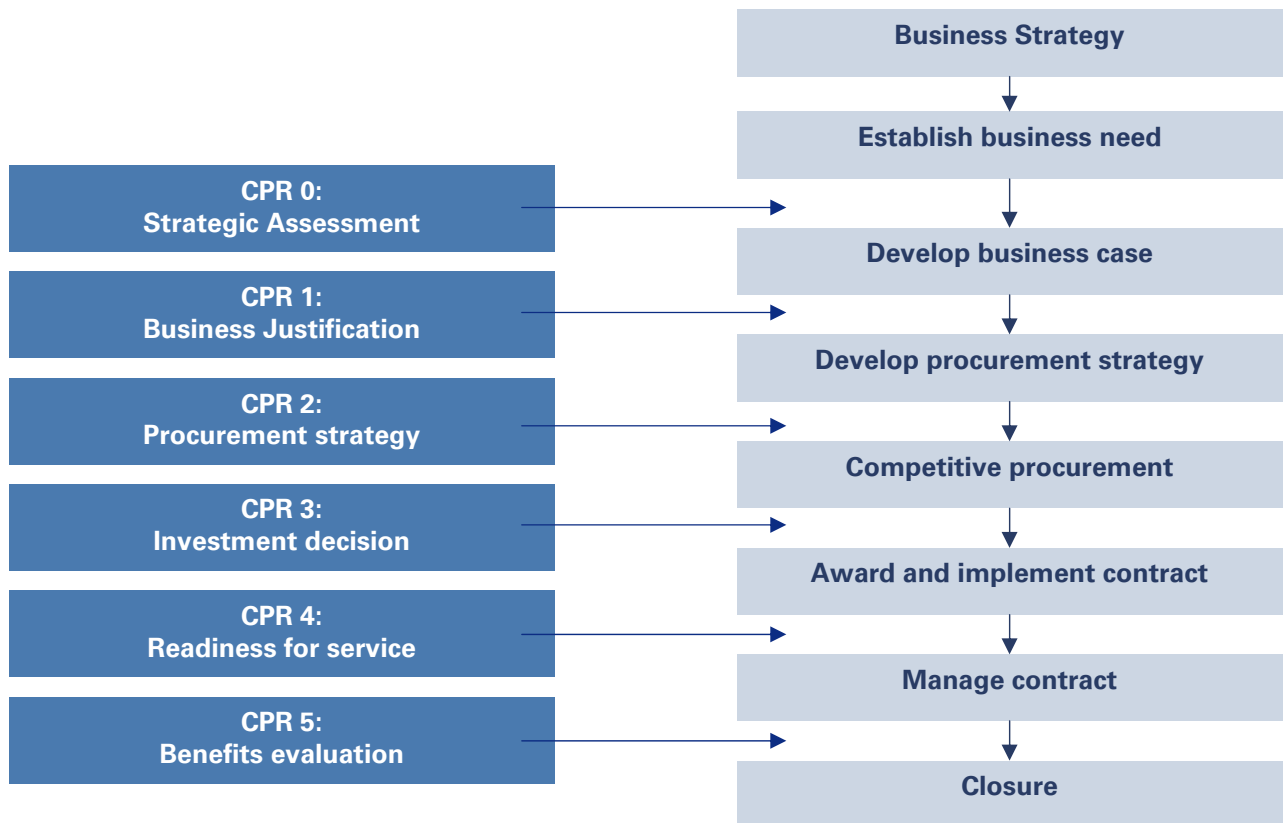
- To provide assurance that projects can proceed to the next stage of development/implementation
- To ensure realistic costs and timescales
- To provide project sponsors with the benefit of the experience of skilled practitioners
- To help avoid costly mistakes

DG Tren made it clear to us that it does not currently have the capacity or expertise to undertake this role; but this may change.

We envisage that there may be up to six reviews. The stages for these are highlighted in the figure below. Each review could last for three to four days. During this period, the EU team of two to three experts could interview project personnel, and check the project was on target by reviewing:

- The direction of the project
- The project management
- The organisational structure
- The funding levels
- The business plans; and
- The procurement process

Again, where the procedures of the Member State were already appropriate, there might be no need for any change – and the review process could be conducted without Commission involvement.



3.1.4 Idea 3: Introduce funding competitions with higher intervention rates for winners

Some level of competition for TENs funds already takes place between Member States. Project proposals are never automatically accepted and funds are limited. For the 20% projects, this could be formalised into a competition. A given level of funding would be allocated for 20% projects, and applications invited from Member States. The projects would be ranked, on the basis of their appraisals, and those with the highest ranking would receive TENs support at 20%.

The difficulty with this idea is that one country might well have more economically attractive projects than another. So there might have to be some geographical spread; but guaranteed budgets for individual Member States would remove much of the value of this idea. Perhaps guaranteed budgets could be retained for projects supported at the lower 10% level. Any scoring system would however need to be very transparent in order to prevent challenge.

We are conscious of the dangers of the Commission selecting winners and losers. But a competition remains a direct way of using limited funds to maximum effect and encouraging high quality project submissions.

3.2 Resolving the payment timing issues

3.2.1 Problem: EU Lump Sum financing pays for Inputs instead of Outputs

In recent years, there has been a change in the way many European governments procure infrastructure: governments are now tendering for and then buying services instead of assets. For instance in Finland, the Government has moved away from buying ice-breakers to buying ice breaking services; in a number of member states, governments are buying rail services or rail capacity rather than railways.. The same principle applies to office accommodation where government now buys accommodation services instead of procuring office buildings.

However, as explained in 2.2, the current TENs grant arrangements only allow for capital payments during the construction period, and are limited to a 7 plus 2 year time schedule.

3.2.2 The role of capital grants in large projects

There can be a good case for paying capital grants into large infrastructure projects even if these are PPPs. Capital grants reduce the need for private sector financing, and reduce the total payment that has to be made. A capital grant does not have to affect the project risk allocation, provided that it is fixed and does not represent too high a percentage of the cost of the project.¹

Our experience with PPPs in the transport sector is that capital subvention of up to the 50% level is still compatible with achieving the objectives of PPP.

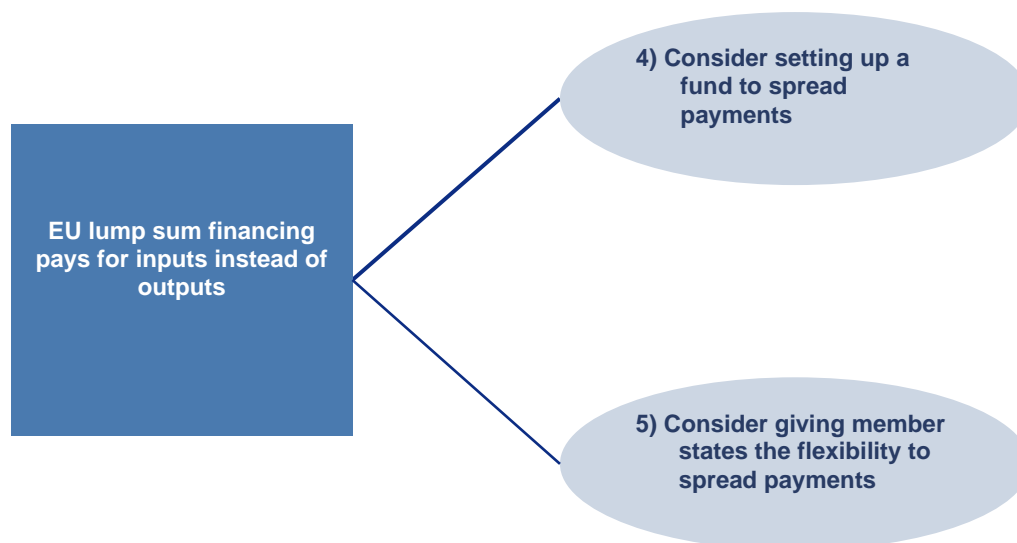
This issue of the effect of grant funding on the balance of risk transfer is more pertinent to Cohesion and Structural funds, where EU grants are available to cover up to 85% and 75% of project costs respectively, than TENs at either 20% or 10%.

The injection of subvention into a PPP does however raise some issues. There will need to be appropriate grant mechanics to allow fixed payments at appropriate milestones. There is a question as to whether the grant should be paid directly to a PPP operator, or whether this should come through the public sector promoter. Our experience is that the public sector will normally be taking the grant risk; so payment through the public sector would seem reasonable.

There is also a question of whether the use of subventions would affect the classification of the PPP for Eurostat purposes. The emphasis in the Eurostat announcement in 2004^{vi} on PPPs is on risk allocation.

The point about this subsection is that it suggests the real problem is that the TENS budgetary regulations cause uncertainty because there cannot be long term commitment. If there is long term commitment, the actual funding could be put into many schemes as a capital injection or to support service payments or both. Some Member States made clear to us that they would prefer a capital injection even within a PPP project framework.

¹ For example, with a €2 billion PPP project, 50% of the financing could come as a capital payment from government/the EU and 50% could be raised from private sources. The private sector would still be at risk for all the overspend, or delay from opening.



3.2.3 Idea 4: Consider setting up a fund to spread payments

The first idea here is that as a way of avoiding the timing constraints imposed by the financial perspectives, the Commission should consider the possibility of paying the TENs grant aid into a fund/trust. The funds would then be paid out to Member States over the required project lifecycle. This could be managed by the EIB, or possibly another bank.

There are existing precedents for the idea of the Commission depositing money at the EIB and these should be investigated further.

On the other hand, there have been problems with adopting a similar approach for the Cohesion and Structural funds. The Member States want to see monies made available in a programming period spent during that period and devices to extract money from the normal budgetary structures will attract scrutiny.

There is also an issue with the current TENs regulation in that the TENs grants can only be used to support construction costs. Grants cannot be used to support operating and maintenance costs. This obstacle is however not insurmountable, it is relatively simple to derive an assumed capital component within a service charge – under a PPP, this could be an availability payment or a government subsidy to help reduce the level of direct user charges.

Setting up a fund would require a change in the regulation. A less interventionist option would be to adopt a more flexible interpretation of the budgetary regulations as described below.

3.2.4 Idea 5: Consider giving Member States the flexibility to spread payments

This is a variant of the previous idea. Here the Member States, rather than the EIB, act as trustees for the grant money. The Commission would pay money for a specific project, and the Member State concerned would disburse the money to fund either capital injections or part of the availability payments during operations.

This might also require a budget regulation change, but may be more acceptable to Member States. Critically, it addresses the real timing problem directly. However, concerns have been expressed about whether the Commission can delegate its responsibilities to ensure the EU budget is properly spent. One way of addressing this issue might be to compel Member States to pay the money into transparently managed accounts which could be audited on a regular basis. We recognise that any change in budgetary regulations could be difficult to achieve and implement.

3.3 Getting the most out of the budget

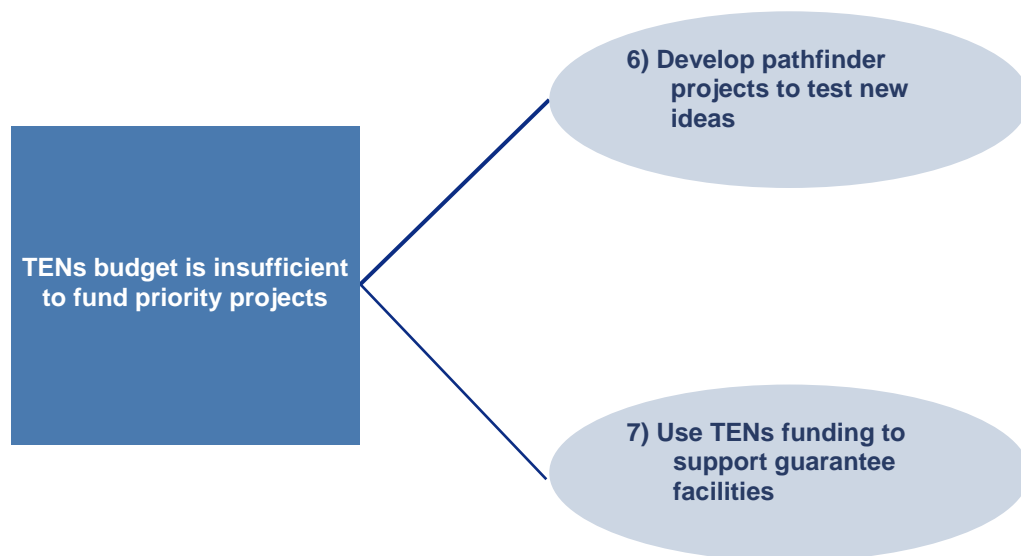
3.3.1 Problem: TENs budget is insufficient to fund priority projects proposed by Member States

As noted in Section 2, the TENs budget is small against the list of priorities identified, and some of the projects submitted for TENs funding may perform poorly with cost overruns.

EU grants should act as an enabler to encourage additional investment in infrastructure, whether from Member States or from the private sector. It is clear from the discussion above that this may not currently be the case.

The challenge for DG Tren is to continue to find new and innovative ways of applying grant aid in order to realise its declared objectives.

PPP-type solutions involving private finance tend to encourage more detailed project evaluation and due diligence which should in turn lead to higher quality projects.



3.3.4 Idea 6: Develop pathfinder projects to test new ideas

The process of amending the original TENs Regulation 2236/95/EU has taken several years during which there has been a substantial amount of policy discussion about the new regulation and about improving the TENs programme. Progress has however been slow.

The idea here is to shift the emphasis away from issuing further policy papers to trying out new ideas through a few pathfinder projects. The private sector will only react and put money into bidding for projects when it sees that there is a real programme developing. Early actions will also galvanise promoters in Member States. Policy and legislation can then be refined from experience. For example, certain projects could be selected to be '20% pathfinders', perhaps through a competition in 2005, and the detailed procedures for appraisals and check point reviews developed around them as discussed in 3.1.3. More generally, the Commission should retain some flexibility when setting new rules so as not to constrain opportunities for private sector participation (as discussed in 2.2).

We understand that certain procedures have to be observed by the Commission with consent sometimes required from the 25 Member States before new policy initiatives are approved. However, a bias for action should produce results.

3.4.2 Idea 7: Use TENs funding to support guarantee facilities

The Proposed EU Guarantee Instrument

The Commission with the support of the EIB, is developing a guarantee instrument, to provide credit enhancement to senior debt repayments during the difficult ramp-up period immediately post-construction. This should help some projects, which may not otherwise have done so, to achieve 'investment grade' rating.

This product is an encouraging development but may need further refinement. Supporting the debt is an appropriate first step. However there may also need to be other equity solutions, in addition to the TENs risk capital facility – both to encourage provision of equity in the first place and to keep it incentivised during periods of low revenue.

Guarantee Fund to cash collateralise the obligations of weak municipalities

We recommend that DG Tren investigates other forms of guarantees such as setting up a fund to cash collateralise some of the obligations of weak regional governments or state companies, or possibly municipalities, who may not have strong enough credit strength (from the point of view of international investors) to stand behind an obligation to make payments over the duration of a PPP project. The monies in the proposed fund would be co-funded by municipalities or national government (to avoid moral hazard) and pooled for each Member State. The Commission's share would come out of the overall TENs grant allocation for the relevant Member State.

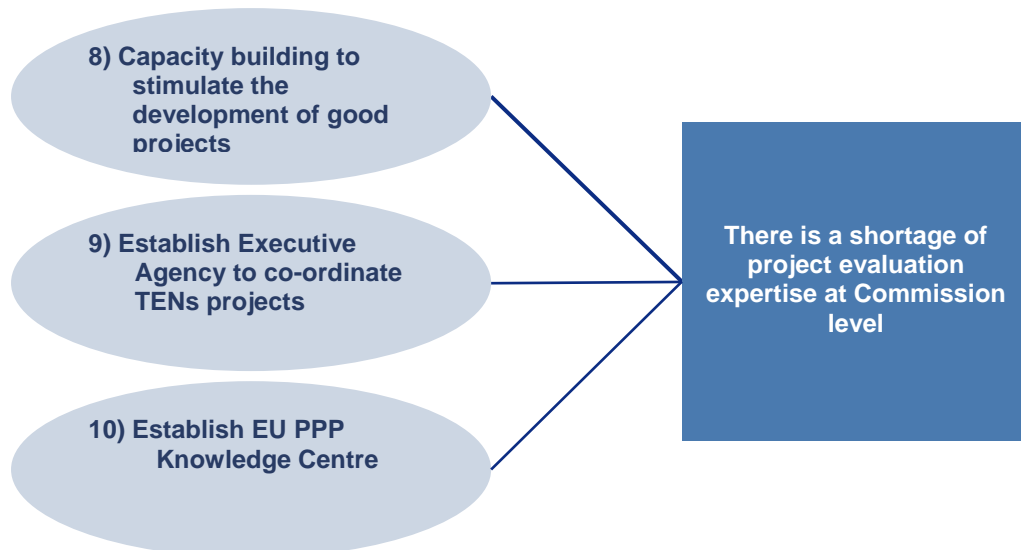
The availability of a Guarantee Fund of this nature would reduce the need for national governments to provide sovereign guarantees for PPP projects undertaken at municipal level. In addition, it would allow the limited available grant funding to be used to leverage in more private capital.

The details of this proposal would require further development in order to determine the exact way in which the fund would operate and its statistical treatment. We understand that the Commission has in the past employed similar guarantee funds to support sovereign debt obligations for pre-accession states.

3.4 Developing the knowledge base and implementation capacity

3.4.1 Problem: There is a poor knowledge base at EU level

The Commission has limited expertise to vet projects and the coordination of PPP work in the EU is only informal. At the same time while some Member States have well established PPP regimes, others do not.



3.3.2 Idea 8: Capacity building to stimulate the development of good projects

Some Member States may lack the capacity to put forward good² projects that meet the criteria required for 20% funding, especially if there is a competition.

The Commission can play a critical role in the development of good projects. It may be able to do this directly through a specialist agency providing advice and support, as discussed below, and it could also encourage applications for TENs grant to support project development costs and transaction costs for PPP projects. We understand that these ideas are currently under discussion. The 50% rate already available to support project development for TENs projects, already provides a strong incentive.

Importantly, extending this grant support to cover transaction costs, for the public sector, would encourage project promoters to employ the right quality and amount of specialist advice and to develop projects properly. As advisers, we have come across projects where the public promoter is prepared to take poor decisions on project structure and tendering in order to save relatively small amounts of money upfront. In the Netherlands early support by the State for public sector promoters' transaction costs was seen as very important in starting the PPP programme.

Another example of capacity building is the twinning approach, under which experienced Member States provide assistance to a new Member States - the Netherlands and the UK are currently twinning with Slovenia on a major rail project. The Commission could play a role in facilitating these arrangements.

3.3.3 Idea 9: Establish an Executive Agency to co-ordinate TENs projects

DG Tren is already considering setting up an Executive Agency to undertake project evaluation, selection and monitoring, but this is only possible if the overall TENs budget is increased for the next financial perspective.

In June 2003, the Karel Van Miert High Level Group recommended the appointment of an EU Co-ordinator to lead a co-ordination team to galvanise progress on cross-border TENs projects. It is envisaged that there will be several EU Coordinators and these would, in order to make a difference, need to be senior figures recognised and accepted by the Member States concerned.

It is our view that the work of EU Coordinators could be supported by the new Agency. In addition, the Agency could also undertake the Check Point Reviews described earlier. The Agency could employ specialist staff, but could also outsource work to experts and consultants.

While the establishment of this Agency is a decision that DG Tren can take on its own in theory, in practice there would need to be consultation with the other institutions and the Member States – not least over the budgetary implications. The Agency can be justified if it leads to better results and to greater cooperation and knowledge sharing, but not if the result is simply more interventionist administration.

3.4.3 Idea 10: Establish an EU PPP Knowledge Centre

The idea of setting up a PPP Knowledge Centre at EU level is not new. There is general recognition (as borne out by responses to the Green Paper)^{vii} of the need for a Knowledge Centre with responsibilities that include developing guidance material, assisting with project negotiations, sharing lessons, identifying obstacles and raising public/private sector awareness of the PPP process in new and old Member States.

DG Tren currently runs an Informal PPP Group comprising representatives from PPP taskforces from some Member States, who meet a few times a year to exchange information about projects and discuss issues of common interest. This initiative represents a good start, but more needs to be done.

A smaller team of experienced PPP experts, drawn from public and private sector personnel from across the Member States would be required to act as secretariat to the Group. This team would tackle project specific difficult issues impeding progress on a daily basis and recommend solutions to Member States. Such a body would carry more weight with Member States than paid advisors because it would be perceived as impartial and lacking a commercial agenda.

² Good in this context refers to projects that meet the Commission's agreed criteria for TENs grant support.

Although this Knowledge Centre could initially be part of the Executive Agency being proposed by DG Tren, it might need to broaden its remit to include non-TENs projects as well as take account of the requirements of other parts of the Commission such as DG Tren, DG Regio, DG Markt and Eurostat.

Knowledge centres have been an important part of how Member States have developed PPPs. An EU body could add value, but only if structured and resourced effectively.

3.5 Other issues

3.5.2 EU Green Paper

The Commission communication of April 2003 on innovative financing for the development of the TENs network states one of its aims as the active promotion of private capital. This communication committed the Commission to publishing a Green Paper^{viii} on PPP and European Contracts law. The Green Paper has now been published and the responses made public³. Detailed discussion of the result of the consultation is outside the scope of this report, but first impressions from reading many of the (over 200) responses are as follows:

- There is very little appetite for more EU legislation to regulate PPPs
- There is strong support for the formation of a PPP Knowledge Centre at EU level
- There is general agreement on the need to build up administrative capacity and procurement experience in many Member States in order to undertake complex PPP projects
- Lender step-in rights are considered essential to raising debt finance and are not regarded as a hindrance to competition
- There are mixed views on the benefits of adopting the competitive dialogue procedure in preference to the negotiated procedure. Many respondents were of the view that the former would increase bidding costs.

In general, the thrust of opinion expressed by the respondents to the Green Paper are in line with the ideas presented in this report.

³ See DG Markt website: <http://europa.eu.int>

4 Conclusions and Implementation

In summary our ideas are:

- 1: Undertake full life appraisal of projects
- 2: Conduct reviews at 'check points' during the project lifecycle
- 3: Introduce funding competitions with higher intervention rates for winners
- 4: Consider setting up a Fund to spread payments or
- 5: Consider giving Member States the flexibility to spread payments
- 6: Develop pathfinder projects to test new ideas
- 7: Use TENs funding to support guarantee facilities
- 8: Encourage capacity building to stimulate the development of good projects
- 9: Establish an Executive Agency to co-ordinate TENs projects
- 10: Establish EU PPP Knowledge Centre

Of these, only Idea 4 and Idea 5 are alternatives, the rest could all be part of an overall TENs policy. Promoting them as a package would provide a clear view of future policy development.

We understand that DG Tren could promote the following ideas on its own initiative, and thus implement them in the short term:

- 1: Full life appraisal of project and structure
- 2: Reviews and break points during the project lifecycle
- 8: Encourage capacity building to stimulate the development of good projects

The following ideas would require agreement within the Commission, or with other EU Institutions, and thus might take longer:

- 7: Use TENs funding to support guarantee facilities
- 10: Establish EU PPP Knowledge Centre

Some ideas would almost certainly require consultation with the Member States:

- 3: Introduce funding competitions with higher intervention rates for winners
- 4: Consider setting up a fund to spread payments or
- 5: Consider giving Member States the flexibility to spread payments
- 6: Develop pathfinder projects to test new ideas
- 9: Establish an Executive Agency to co-ordinate TENs projects

As noted in the introduction, this study has been undertaken within a short time frame with limited access to relevant EU personnel. Most of these ideas will therefore require further discussion and development to bring them to fruition.

NOTE 2:

Shifting the focus of grant aid from construction costs to operating and life-cycle costs

Project appraisal

Introduction

The purpose of this note is to serve as a policy document aimed at helping promote a shift in thinking within the Commission and Member States, from a focus on construction costs to that of operating and lifecycle costs. We have explored the issues through a set of key principles to be considered when conducting whole of life appraisals on TENs projects. The recommendation to the EU Commission is that an appraisal which meets these principles should be required for all projects which are applying for funding from the TENs programme at a rate greater than 10%. Such an appraisal would also promote good practice on other TENs and transport projects.

This note is not a full appraisal methodology; this would require a substantially longer document. There are two options for the EU Commission over the appraisal methodology: it could develop its own TENs appraisal methodology and require the use of that methodology for all applications; or it could accept appraisals conducted under national rules which meet the key principles discussed in this note. An EU methodology might still be useful for projects which cross national borders or for Member States which do not wish to develop their own methodologies.

Principle 1 – There should be both an economic and social appraisal and a financial appraisal

There are two separate questions for transport projects. The first question is *'is this a worthwhile project?'* As few transport infrastructure projects can be justified on purely financial criteria, this normally requires an examination of the wider economic, social and environmental benefits of the project and a comparison against the costs. In the case of TENs, the extent to which the projects add value and promote the socio-economic and territorial cohesion of the EU is also a key consideration. The appraisal should include a consideration of alternative schemes, one of which is normally a *do-minimum* option.

The second question is: *'is this project being procured in an appropriate way?'* This requires a consideration of different ways of procuring the project. These can include traditional public finance options as well as PPP options.

Taken together, the answers to these two questions should provide an indication as to whether a project should qualify for TENs support.

Principle 2 – Consider project lifecycle costs and benefits

This note argues that the "whole-life" cost of any major infrastructure project needs to be analysed before the project is approved and the cash flows from government (by way of grants, availability payments, or subsidies) need to be matched to the long-term funding requirements of the project. This is fundamentally different from current approaches in many Member States where government funds are only guaranteed during construction. By contrast, ongoing support for subsequent maintenance and refurbishment is undertaken on an ad-hoc basis.

In general, lack of maintenance leads to a reduction in the value of an asset and its usefulness. This has financial consequences for Member States. Under-maintained infrastructure in general generates lower returns and can lead to further damage of the asset. e.g.: poorly maintained railways lead to delays (loss of revenue) or accidents (further damage to the asset). These concepts are well understood and can be quantified and predicted by engineers; however engineers are often ill equipped to translate predictive maintenance requirements into financial arguments and frequently do not convince management or eventually the government of the need for early regular maintenance.

Traditional project appraisal tends to focus on the upfront capital investment instead of the lifecycle or 'whole life' costing of a project. Evaluation based on initial capital investment often results in sub-optimal projects: project promoters are encouraged to come up with short term solutions without considering the long-term cost effects. A whole of life approach, by contrast, encourages more efficient maintenance planning and careful thinking over the impact of the original design on continuing maintenance and

operational requirements. Integrating different elements of the value chain in one contract can also improve efficiency of investment and maintenance/operation over the lifecycle of projects.

The approach being advocated here requires the Commission to encourage Member States to include an estimate of the maintenance and life-cycle renewal requirements of their projects in their initial project evaluation and translate these into financial (net present value) terms. It is only through this “whole-life” analysis that Member States can expose the true cost of an infrastructure project as well as the expected timing of those costs.

The whole-life cost calculation fits well with the concept of PPP. Private companies entering PPP contracts have a long term investment horizon and will normally operate the infrastructure asset after construction. The government payouts for PPP occur during the service lifespan of the asset and are linked to performance. This means that companies entering PPP contracts are forced by the nature of the contract into taking a longer term view.

Although not all TENs projects will be suitable for PPPs, a proper options appraisal needs to be undertaken. Comparing traditional procurement and PPP can be problematic if the assessment of the traditional route is purely focused on the construction phase of the project.

Undertaking such a comparison on a “whole-life” basis creates a level playing field where the more appropriate procurement method will recommend itself, and can be fairly selected. It also allows the public sector to benchmark its practices against the private sector over the longer term.

Principle 3 – There should be a comparator and a shadow bid

The Public Sector Comparator is an estimate of the risk adjusted whole-life costs of the project, if procured by traditional public sector means, expressed in present value terms. This calculation should set out the projected capital, operating, maintenance and lifecycle renewal costs of the project and take into account the risks that may be transferred under the PPP.

A Shadow Bid is an estimate of the overall cost of private sector service delivery under a PPP arrangement over the project lifecycle, expressed in present value terms. The Shadow Bid will normally be constructed around a private sector bidding model and will include an expected private sector financial structure, as a pricing of risk.

There is considerable literature in the public domain on how to construct PSCs and Shadow Bids.

Principle 4 – There should be an assessment of risk, and optimism

It is important that the appraisal of costs, duration and benefits should include assessments of, and allowance for, the associated risks and uncertainties. Risk analysis forms an important part of the comparator work. A traditional public sector approach may seem cheaper at the outset, but may lead to a worse outcome once the risks over the life of the project are taken into account – particularly if the public sector has a pattern of managing such risks poorly.

In Member States such as the Netherlands and the UK, there is a growing realisation of the need to distinguish between risk and optimism. At any stage of the project, risks are the known factors and optimism represents the factors that are as yet unknown and not taken into account in the specific risk analysis.

The techniques for undertaking risk analysis and estimating optimism bias are well known, but are better developed in some countries than others^{ix}.

Principle 5 – The discount rate should be explained

The public sector discount rate is the rate that is used to discount public sector's future cash flows to present values in order to calculate the NPV cost of each procurement option. Discounting is a technique used to compare costs and benefits that occur in different time periods. The selection of an appropriate discount rate is usually a challenging exercise and has a significant impact on the final analysis. There are several approaches to determining an appropriate discount rate used in different Member States. Guidance is usually provided by the finance ministries in the Member States.

Principle 6 – There should be an affordability test

This is a purely financial part of the appraisal. It takes the expected cost of the project, over the lifecycle and looks at how affordable it is for public sector organisations with payment responsibilities. It will also assist the Member States to identify the extent to which EU grants are required to plug any funding gap.

Principle 7 – The appraisal should not be a ‘one-off’

Project appraisal should be carried out throughout a project life-cycle, especially when the business case is updated. At the various project stages the appraisal methodology should provide decision makers with information on the status of the project. The ‘Check Point Reviews’ described in Note 1 provide assurance that projects can progress to the next stage of development/implementation. These reviews enable decision makers to intervene if costs, benefits or timescales seem unrealistic and therefore no longer represent value for money. It offers decision makers the opportunity to adjust a project or in a more extreme case stop a project. This may help to avoid costly mistakes. At the same time it puts pressure on the project promoters to deliver the project benefits as stated in their proposals.

Principle 8 – The limitations of appraisal should be understood

The appraisal work, and in particular the use of comparators should not be overdone and over relied upon.

A few key issues are worth bearing in mind:

- Both the shadow bid and the comparator are estimates initially undertaken at an early stage of the process, and must be subject to change to reflect new relevant information
- The estimates, which should be prepared on a reasonably cautious basis, may not take account of innovation in both private and public sectors
- The whole of life results for any project cannot be fully understood until the project has reached its economic life – perhaps 30 years after its completion
- There is a shortage of post project evaluation studies to establish actual cost outturns on major infrastructure projects during entire project life, including construction and operation
- Risk factors are not independent, and the correlation can be hard to capture
- Quality issues can be hard to value
- There can be issues over the right level of discount rate to use
- The commercial structures need to be known to determine the appropriate risk allocation (even though an outline risk allocation for various structures can be used at the outset); and
- The process can become so complicated that the participants no longer understand it

These points have led senior members of the UK National Audit Office, which has reviewed many comparators to comment that too much emphasis is now being placed on comparators – and in particular on single quantitative results from them. Comparators are an aid to good quality judgement, not an analytical substitute for it. Many of the same points apply to wider socio-economic appraisal of projects.

ANNEX A

EU Commission and EIB proposed criteria for selecting projects to qualify for intervention rates above 10% of construction costs

Financing TENs projects beyond 10%^x

According to EU Commission decision 807/2004/EC, Community aid can exceed 10% only for projects that:

- Concern satellite positioning and navigation systems
- Are on the energy networks
- Are of European interest (identified in Annex III to Decision No 1692/96/EC)
- Eliminate bottlenecks
- Cross borders or a natural barrier (to be defined by TENS committee)
- Contribute to integration of the internal market
- Promote safety, ensure interoperability of national networks
- Contribute to the reduction of imbalances between modes of transport in favour of the most environment-friendly mode

In interpreting the requirements of this Decision, the Commission has proposed that the application for supplementary financial assistance shall be accompanied by:

- A financial analysis by the project promoter which demonstrates that supplementary financial assistance is essential for project implementation
- Reassessment by the EC and EIB of the economic and financial viability of the project as well as direct or indirect socio-economic effects
- Economic assessment
- Estimation of the need for subsidies based on projected revenues
- Analysis of community added value based on cross border or cross natural barriers – projects are eligible where they represent cross border sections between Member States, technically and financially indivisible and for which Member States have in place a common structure

Applications for support exceeding 10% will therefore be more complex requiring additional data to be presented by Member States.

EIB has also put forward proposals on how projects should be assessed for additional support from the TENS budget. These are based on three fundamental criteria:

- Project quality: projects with poor technical and/or economic viability should be sent back for re-examination; projects should be properly defined and a standardised method for cost benefit analysis adopted.
- Need for subsidy: priority should be given to projects that require the highest subsidy levels, calculated by taking the difference between the NPV of project costs and revenues.
- Trans-European component: priority should be given to projects that benefit the EU as opposed to just the host nations. This can be done by estimating the proportion of economic benefits not covered by user charges outside the host states of the project – this portion should be supported from the community budget.

End Notes

End Notes

- ⁱ DG Tren Memo: Priority projects for the Trans-European Transport Network up to 2020
- ⁱⁱ Procedures for dealing with Optimism in Transport Planning – UK Ministry of Transport (2004)
- ⁱⁱⁱ EU Commission Communication dated 11 November 2003
- ^{iv} “The Cohesion Fund in evolution” by J. Walsh. Inforegio Panorama 14 September 2004
- ^v DG Tren Paper: Financing TEN-T projects beyond 10%; and EIB Discussion Paper: A potential methodology for evaluating the eligibility of projects for co-funding from the TENs budget line beyond 10%.
- ^{vi} STAT/04/18 (11 February 2004) - New decision of Eurostat on deficit and debt: Treatment of public-private partnerships
- ^{vii} DG Markt website: [http:// europa.eu.int](http://europa.eu.int)
- ^{viii} Com (2004) 327: Green Paper on PPP and Community law on Public Contracts
- ^{ix} Review of Large Public Procurement in the UK, July 2002, Mott MacDonald
- ^x DG Tren Paper: Financing TEN-T projects beyond 10%; and EIB Discussion Paper: A potential methodology for evaluating the eligibility of projects for co-funding from the TENs budget line beyond 10%.