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PUBLIC-PRIVATE PARTNERSHIP AND HYBRID PROJECTS AS AN EFFECTIVE METHOD FOR FINANCING LOCAL GOVERNMENT INVESTMENT PROJECTS

Abstract

The new reality forces local governments to look for alternative methods to finance their structural investment projects. Apart from the EU funds, available effective methods of financing may also include public-private partnership and hybrid Project.

This requires unification of project documentation and introduction of more favourable legal regulations.

Key words: public finance, the effectiveness and efficiency of public service delivery, public sector, EU funds.

Introduction

As a result of post-1989 transformations, local governments no longer operate in a relatively stable and constant environment, also in terms of finance. Nowadays, local governments must analyse budgetary proceeds carefully, look for sources of new income and strive for successive development. In 21st century, local governments count on long-term planning, in particular in the light of continuous changes in their immediate and general environment and a continuous attempt at compromising the continuously growing needs of local residents and their limited funds.

At present, a considerable portion of investment projects run by local government entities is financed mainly from EU funds raised through participation in various projects, e.g. regional operational projects. Another, still insufficiently appreciated method for supporting a local government budget is public-private partnership (PPP). This is a commonly known but not a broadly used concept. While recently, there has been a clear positive trend in applying such investment project financing formula, while ensuring optimal distribution of expected project risks, considerably more investment projects are financed from the EU funds.

A concept of PPP hybrid projects emerged to supplement the classical PPP concept. A hybrid PPP model is a combination of a PPP structure with EU funds to finance a specific element of infrastructure. In hybrid projects, funds can be combined under the same contract or a part of an investment project of the public sector may be financed from the EU funds, while the private partner finances construction of the remaining part of the investment projects and, later on, operates the entire investment project. Hybrid projects are used in many areas: roads, waste, tourism, hospitals and schools. There are many benefits from applying the PPP model, while a combination of the PPP and EU subsidies is an optimal solution, at least in case of specific types of investment projects.

This paper is an attempt to present some of the problems associated with the use of PPP and PPP hybrid solutions in local governments based on the practical application of this formula.

Public-private partnership in Poland

Around the world, a PPP formula of an investment project has been considered exceptionally advantageous for many years. Joint projects allow for increasing effectiveness of public services by sparing risks and drawing from the experience of the private sector [Sikorski, 2013]. In Poland, public-private partnership (PPP) is popular but still not well understood concept, which is not applied at a large scale. PPP is a partnership of a public entity and a private partner in a joint project, based on sparing and dividing tasks and risk between both parties [Waśkiewicz, 2013].

The most common obstacles faced by PPP include inappropriate preparation of investment project, which comes as a result of insufficient knowledge and experience. The latter, in turn, is the outcome of the inability to have access to reliable information and PPP-related consulting. Excessive expectations of public entities towards private partners, inflexibility in negotiations, inappropriate distribution of risks and tasks between entities are factors which very often doom an investment project to a failure. In addition, it is a misunderstanding to approach PPP as a public order award by the public sector. PPP is a long-term contract between the public and the private sector on their collaboration until it expires. In addition, the public entities are obliged to control continuously provisions of the PPP contract by the private partner [Maciejewski, 2012]. Regulation on the general obligation to balance operating costs with operating income as well as the new formula for calculating the permitted debt of local government entities have a major impact on the application of the PPP formula in investment project implementation. Another issue is own contribution of the public partner. The private partners undertakes to implement an investment project for a fee and shoulder, in whole or in part, expenses and costs of its implementation or transferring

them onto a third party to shoulder them, while the public entity undertakes to collaborate to reach the goal of the project by making its own contribution [Siwoń, 2012].

Still, recent years have brought a clear positive change in perceiving this form of investment project financing. Earlier on, there were no legal acts that would make the collaboration between the governmental and local sector and private entrepreneurs possible. However, adoption of the public-private partnership act and the Act on Construction Works or Services Permits Act made implementation of investment projects under the PPP formula easier [Sikorski, 2013]. In addition, the PPP Act and the Public Finance Act unambiguously determined that it was allowed to contract long-term liabilities under the PPP both at the state and local government level. For many years, the 1-year budget principle stood in the way of contracting long-term liabilities by the public finance sector entities. Mechanisms ensuring financing of such projects were not in place. There was also a risk of declaring liabilities contracted for a PPP projects as going beyond one's competences. At present, the Budgetary Act defines the limit for budgetary liabilities under PPP contracts for state administration agencies in a financial year [Herbst, Jadach-Sepiolo, 2012].

The PPP formula is attractive to local government activities as it could remedy budgetary issues of local government entities and offer an alternative solution to financing investment project. In the PPP formula, project financing may be distributed over many years and does not require spending considerable amounts of money on costly investment projects over a very short period [Siwoń, 2012]. PPP investment project formula is characterised by its:

- long-term delivery;
- distribution of tasks;
- distribution of profits;
- risk distribution [Sikorski, 2013; Kalinowski, 2013].

In Europe, PPP is a popular and broadly applied method to finance needs arising in the public sector. The above-mentioned benefits come from looping for additional costs of funding and include a shorter period for implementing investment projects and the possibility to have a long-term financing plan for an investment project. Unfortunately, in spite of the introduced regulations, PPPs do not enjoy the popularity they deserve. Still, local governments are the main public investor working in the PPP formula. In the last few years, local government organised most of the procedures to select private partner, they also initiate activities aimed at disseminating and sharing their experiences in PPP projects implementation, promoting specific projects. This formula is included in the investment offer of local governments. However, it can be expected that PPP advantages will be more appreciated when raising EU funds is more difficult. In the light of the above, one may see that PPP and EU funds are not mutually exclusive.

Hybrid projects – EU funds in PPP projects

Polish local governments may benefit significantly from investment projects and provision of services in the PPP formula. A hybrid PPP model is a model which may prove particularly efficient. A hybrid PPP model is a combination of several sources of project financing, i.e.:

- 1) public funds from e.g. the local government budget;
- 2) private funds from a private partner;
- 3) EU funds, i.e. co-financing or subsidies.

One may consider it peculiar to connect financing investment projects with private funds with financing from the EU, but such connection is possible. It is not a simple solution but it can bring immense benefits [Waśkiewicz, 2013; Piekarski, 2011; *Using EU Funds in PPPs. Explaining the how and starting the discussion on the future*, 2011].

Projects integrating a PPP model with EU funds are subject both to PPP rules and the rules that apply to EU funds. On the one hand, such projects are prepared and implemented in accordance with the PPP Act or the Act on Construction Work Permits while, on the other hand, they must observe the rules for planning and settling costs specified for an operational programme co-financed from EU funds [Sikorski, 2013; *EU Funds in PPPs Project Stocktake and Case Studies*, 2012; *Combining the Public-Private Partnership Model with EU Funds*, 2013].

While hybrid PPP projects are not easy in implementing, they have been used for years in other EU member states; still, the extent of their use has been rather limited. Model examples of such projects include the ring road of Athens, a water treatment plant near Dublin, Ireland or a rail connection between France and Spain [Cieślak, Michalak, 2011]. Experiences of the „old” EU 15 show that, with the PPP model, effective collaboration of the public and private sector with the EU participation could be achieved. All countries – beneficiaries of the Cohesion Fund and structural funds in the old EU states (Greece, Ireland, Portugal and Spain) received and adopted the PPP concept with a good result. At the same time, they became significant beneficiaries of EU funds; still even there very few hybrid PPP projects were delivered. The **European PPP Expertise Centre** set up by the European Commission, European Investment Bank and EU member states identified as few as 49 such projects in Europe, and, what is interesting, as many as 14 of them is being implemented or prepared in Poland [Sikorski, 2013; Gajewska-Jedwabny, 2005; *Combining the Public-Private Partnership model with EU funds*, 2013].

In case of hybrid projects, involvement of a private partner improved effectiveness and the benefit indicator. In turn, EU involvement played a very important role in enhancing creditworthiness of the project before other project partners. In addition, the EU ensured that the initial costs of the project studies were paid and institutional support provided; however, a hybrid PPP cannot be approached as a solution fit for all planned structural investment projects in Poland. Because

of engaged both EU and private funds, all issues of raising EU financing and setting terms and conditions of partnership with a commercial entities are focused in a hybrid PPP [Gajewska-Jedwabny, 2005]. Such financing structure can be used in case of investment projects that require substantial financial investment from sources other than local governments and their sources of income. An EU-subsidised PPP project results in delivering public tasks which otherwise would generate no return. The subsidy limits financial costs of the private partner, reducing his demand for external financing the investment project. Participation of EU funds in PPP-type projects comes as a very important element because of providing financing but also as a validation of the project importance for the public in the eyes of private entities. In addition, EU funds may also guarantee that the costs of preliminary project studies are covered and necessary institutional assistance provided [Waśkiewicz, 2013].

Other benefits from implementing a project with the mixed formula, on the basis of the experience summarized in the Table 1.

Table 1

The potential benefits and risks of hybrid PPP projects

Potential benefits	Potential disadvantages
<ul style="list-style-type: none"> – value for money; – optimization of the design and operation; – risk transfer; – increased investment in public infrastructure; – increased budget / financing certainty; – political advantage; – private sector growth and stability; – co-financing from the private sector as a limitation of budgetary liabilities combined with stimulated infrastructural development; – higher quality of services provided; – reduction of operational costs as a result of the “full project life cycle” approach; – effective use of subsidies; – typically faster delivery of the investment phase. 	<ul style="list-style-type: none"> – higher cost; – reduced competitiveness; – lack of capacity; – rigid / inflexible / long contracts; – delays and holdups; – double taxation; – less accountability/transparency; – need for public sector capacity and skills that may not be available; – loss of democratic control, potential for negative public reaction to profit; – long term limited flexibility and risk of disagreement between public and private sector.

Source: based on: *Fundusze Europejskie szansą rozwoju PPP w Polsce*, 2009, p. 52; Dhéret, Martens, Zuleeg, 2012; Colverson, Perera, 2012.

As described above, a well-prepared project delivered in the hybrid PPP model brings profits to local governments. The formula is difficult to prepare and deliver, as it requires a considerable effort put in analysing and planning the entire project. In consequence, the projects demonstrate improved timeliness when compared to public investment projects, do not exceed the planned budget and offer a better quality/price ratio owing to a more precise identification of beneficiaries' needs.

Local governments' experience in hybrid projects

Hybrid projects in Poland are financed from funds available under regional programmes delivered by Offices of Heads of the Local Government of the Region at the regional level and from programmes implemented nationally. In 12 programmes in 2007–2012 financial perspective, 19 hybrid projects were identified. 16 (out of 19) of them have already executed co-financing contracts and they are the most advanced in terms of selecting their private partner. Three other projects in the pipelines, still awaiting decisions on the co-financing, are at their conceptual and planning stage to be implemented under three Regional Programmes of the Pomeranian, Silesian and Lubuskie Region. 9 (out of 16) projects are telecom sector projects and represent the majority of projects with EU funding support. Their implementation will result in full achievement of the target set out in the Eastern Poland Development Plan and the Greater Poland, Lower Silesia, Lesser Poland and Mazovia Regions. The remaining 7 (out of 16) projects, having their co-financing contracts signed, will be implemented in 5 different sectors, including: waste management, revitalisation, innovation, sports and recreation and energy efficiency. **The most advanced projects in terms of their private partner selection are described in** Hybrid Project Base available on the PPP Platform website (<http://www.ppp.gov.pl>) and will not be discussed in this paper. However, it's important to give some examples illustrating how broad the range of possible investment financing offer is when it comes to financing the hybrid PPP model.

The highest number of projects is lined to introduction of the IT. It is about building a broadband Internet network in Eastern Poland, in the following regions: Świętokrzyskie, Podkarpackie, Warmińsko-Mazurskie and Lubelskie, Małopolska broadband network and Wielkopolska broadband network and managing its infrastructure. Other projects apply to the municipal infrastructure, scientific, sport and recreational infrastructure, to mention building a mineral aqua complex in Solec Zdrój, revitalised Railway Stations and their neighbourhoods in Sopot, building the Waste Management System for the City of Poznań, etc. [*Baza projektów hybrydowych*, 2013; Jędrzejewski, 2013].

The majority of PPP project formula is applied in Poland for delivering small investment projects; however, there are some exceptions to this rule, including the above-mentioned waste management system in Poznań, with its estimated costs of PLN 1.041 billion, including EU financing of PLN 352 million. Hybrid financing increases complexity of projects which are complex by definition and is very time-consuming. Poznań project shows that such financing variant is doable while it is uncommon even at the European level and the first of the kind in Poland [Dębiec, 2013].

It is not possible to indicate an ideal PPP model supported by EU funds. It is because an optima collaboration method is dependent on many factors, such as the area (subject) of the partnership, availability of financing of a purpose, requirements about the status of beneficiaries. The above-mentioned elements have a direct impact on the division of investment tasks and risks among

partners. The division may vary, dependent on what the partnership concerns. Implementing a hybrid project, it should be agreed upon as early as at the stage of preparation, who of the partners will apply for the EU funding and obtain the beneficiary status at the same time. While, in theory, it is admissible that both a public entity and a private partner have such status, the application may be filed by the party what will meet the requirements of the operational programme under which the support may be awarded. In addition, there are many ways to implement the hybrid: from the “full” variant, including preparation and delivery of an investment project with EU funding, through a private investor to a mixed model, which assumes EU funding to finance only a part (stage) of a project by a public entity to the operator’s variant, i.e. managing the infrastructure co-financed by the EU. The first contracts supporting the PPP with EU funds, which have been executed so far, may be called successful only after delivery and settlement of the projects. The experience in implementing the traditional PPP formula shows that some projects were more successful than other. The latter are very well exemplified by the investment project “Gostynin Thermal Resort – Central Park for Recreation, Balneology, Tourism and Recreation” which ended with bankruptcy of the private investor. Still, it is comforting to know that, at least some local governments decided on using the pioneer method for merging capital. Unfortunately, in the present programming period 2007–2013, one may see as early as now that very few similar contracts have been signed. There are very basic reasons for it. The legislature which governs the principles of the PPP and financing the Cohesion Policy of the EU in Poland, include only a very general indication of the possibility to implement hybrid projects while systems for implementing specific operational programmes have very brief references to this issue. For this reason, institutions who manager programmes usually have rather theoretical assumption on a possible co-financing of the PPP. Guidelines and, first and foremost, know-how and commitment to such new and difficult projects as PPP projects undoubtedly are, are not in place. On top of that, hardly any examples of projects delivered are available that would combine both forms of financing. For this reason, both project applicants and beneficiaries are rather sceptic about it [Cieślak, Michalak, 2011].

As of now, it is not possible to assess whether hybrid partnership models offer a good solution to deliver public – private partnership projects in absence of examples of a successful partnership based on a hybrid model. However, such model has been used and proved successful in other EU member states. In each case, a project must follow an in-depth economic and legal analysis and selection of a model will be dependent on a variety of issues involved. Further to the above, one may guess that the different PPP formulas in Poland will grow in popularity as methods applied to satisfy social needs.

Summary

A rapid economic growth forces development of infrastructure and the public service sector. On the other hand, the existing budgetary limitations force local governments to look for alternative solutions allowing for achievement of their goals. To achieve effective financing of its infrastructural development, the public sector is forced to look for new sources of funding. The EU funds, available for many years have been, so far, the most popular form of investment financing. On the other hand, according to long-term financial forecasts, availability of the EU aid will be shrinking. This is why the importance of the PPP is growing.

The PPP is about joint implementation of a project by a public partner and a private partner and comes as an alternative to financing public tasks exclusively from the state and local government funds. PPP is recognised globally as a solution with many advantages. Hybrid PPP projects are based on a concept of financing a planned investment project from public funds, funds of a private partner and EU funds. Undoubtedly, hybrid PPP projects have the advantage of raising a considerable capital by a public entity to start an investment project. To use this opportunity, the project must comply with requirements and restrictions that come with EU fund raising.

At present, Poland can boast on some successful projects delivered in the PPP formula and mention some that were not as successful. While foreign practice indicates many benefits of hybrid project implementation, the number of good practices in this area is still insufficient, as currently implemented projects are now at the more or less advanced chase. Such financing model will be commonly recognised when the projects, which are not in the pipeline, are settled. Successful examples will serve as models and success stories to others. These efforts will bring about development of inexpensive infrastructure which will contribute to regional growth in Poland. However, so far, hybrid PPP projects are considered very risky.

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