Mihály Varga

PPPs in Hungary – Do They Hurt Us or Help Us?

Analysis on how PPPs work, how they are viewed, how they come into play domestically, and what types of problems do they trigger

Recent economic news often mentioned PPPs as modern business configurations. However, the wealth of news reports and statements on the subject have done very little to tell people what they actually are. Are they just a new privatization trick in which private market players are the only winners, or are they the financial world's miracle balm offering a win-win situation to all players?

The English term Public Private Partnership (PPP) might suggest to some people that they were looking at a revolutionary foreign configuration newly introduced in Hungary, even though the essential idea behind it – the attraction of financial and intellectual resources from the private sector to become involved with public investments – is far from new to Hungary. One very early example actually dates from the mid-19th century and was a contract to build and operate Budapest's Chain Bridge, the first bridge spanning the Danube at this geographical location. Projects that are more recent include concessions that were outsourced in the years following the regime change that mesh well with the PPP concept (such as construction of Motorway M5).

The goal of this analysis is to offer an approach that manages to navigate the considerable amount of often contradictory information and views on PPPs. To progress beyond the – sadly often-bias – statements by domestic opinion-makers and "experts" – and conclude this article – I will briefly outline three PPP project case studies, two of which are Hungarian and one of foreign origin, and discuss the advantages and disadvantages of each.

THE CONCEPT, ROOTS, AND MAIN GOALS OF PPPs

Some countries introduced Public Private Partnerships as a form of cooperation between the public and private sectors before the 1990's. Cooperation between the public and private sectors has been a popular financial configuration in the United States, Ireland, Spain, Portugal, and the United Kingdom, even though it is not an easy task to come up with an accurate definition of the "magic" term, PPP. In a board sense, the PPP is a financial construct – that must including risk bearing – in which the state commissions a private business to offer a public service. In the narrower sense, a PPP is a longer term (possibly 20-25 years long) cooperation project between the public and private sectors in which a private business – which takes the risk – attempts to provide a public service through shared ownership or reverse leasing. The financial structure of this latter PPP differs fundamentally from the old economic position, which states that most of the time major investments are needed to provide public services, which are government tasks because of their significantly large size.

In Hungary, the Internet website of the Ministry of Economics and Transport – the most official source on the subject – defines the con-

cept, which is employed extensively in countries to the west of us, as follows:

> *"The PPP (Public Private Partnership) is a manner of meeting public tasks in which the government – through competitive bidding – includes the private sector in establishing, maintaining, and operating the facilities and/or institutions it needs. Within the PPP framework, the private business offers a service to the state by taking over a government task. The government and/or the actual users of the service pay a fee for the given service. In this configuration, the government, as the body ordering the service, defines the service itself, the quality, and the length of time that it plans to use it – typically 20 to 30 years. In other words, the service is provided by the private sector and the state acts as monitor."*[1]

There are two reasons why this study is focused on this increasingly popular form of public procurement. One is Hungary's steadily swelling budget deficit, while the other is the spread of a new type of support policy resulting from membership in the European Union. We are now in a position to gauge the short, medium, and long-term targets, opportunities, and consequences of including private capital and private services in the public sector. If they are regulated vigilantly, they may be able to trigger a transformation of public finances as well.

A modern infrastructure is fundamental to the smooth operation of a national economy. When an economic environment is evolving, it is necessary to strive for providing the appropriate quantitative and qualitative conditions (such as institutions of public administration, energy distribution networks, telecommunications, information technology, and corrections institutions). Moreover, anti-depreciation measures need to be taken in order to protect the value of material property and prevent significant increase in expenditure in the future.

Extensive analysis and planning can improve the effectiveness of the PPP configuration. When conducting these analyses, we must be able to demonstrate the economic and demand effects triggered by the regulatorions (meaning how they fit into the legislative environment and how applicable and executable the regulations are). Since the method involves a long-term commitment, changes in public finances or in the macro or microeconomic environment may necessitate the introduction of new tools. Moreover, it maybe essential to reinstate earlier methods and regulations or conversely, to terminate some that are still in effect. The PPP configuration still has not really taken shape in Hungary, although it is being investigated extensively. In fact, initial attempts have been made to govern it legislatively.

THE INTERNATIONAL SITUATION

The "magic" term, PPP, really began to spread throughout Europe in the 1990's, mainly because of the Maastricht Treaty signed on February 7, 1992. In Maastricht, the foreign and finance ministers of the EC countries set down the criteria for establishing a monetary union. These criteria are stabilizing price levels, stabilizing currencies, bringing interest rates into convergence, and stabilizing budgets. Stabilizing budgets means on the one hand that the current budget deficit may not exceed 3 percent of GDP, while on the other, the national debt must remain below 60 percent of GDP. For the countries that joined in the first round, an anually decrease in national debt level was set as a criterion for countries with national debt level over 60 percent. Keeping the current public finance deficit within 3 percent of GDP continued to be a requirement for the various countries during their budget preparation, even after the introduction of the common currency, the euro. To make it possible to compare the methods used by various members to calculate their public finance deficits, a uniform method (called ESA 95) was introduced. Later, sanctions were also defined. When the Maastricht Treaty was signed, the European economies were growing, and it was unimaginable that holding the current budget deficit and/or the national debt at the pre-determined levels might become a problem for them.

Since Maastricht, the state of the economy has defied expectations globally as well as in Europe. Germany was most badly hurt during

the past decade. As the economic engine of Europe, from the moment of German reunification, it offered a great deal of assistance to the eastern regions, generally without any efficiency expectations. In the meantime, it faced the problems of population decline and growing unemployment. The result was a slowdown in economic growth and deterioration in public finances. The slowdown of the German economy had a negative impact on economic growth in all of Europe. Germany, Austria, and France were all forced to cut back on welfare reforms and benefits. However, the economy really needed sharper cutbacks than what was politically bearable. It became clear by the early 2000's, particularly looking at Germany, that while unpopular welfare reforms were eroding the popularity of governing parties, they were not improving the economies. The cuts in expenditure were not enough to keep the deficit down to 3 percent of GDP, nor have they been enough to jump-start the economies.

One item of debates on the European Union's 2007-2013 budget was the revisiting of the Growth and Stability Pact (GSP) amidst a slowing economic environment and a rise in laxness in keeping to Maastricht rules. The six countries that are net contributors to the EU – Germany, France, the UK, the Netherlands, Austria, and Sweden – want their payments reduced, while a number of them – and others as well –have also lobbied to keep certain expenditures off budget in their accounting, which cuts deficits on paper. On March 20, 2005, they reached a compromise to loosen up the GSP. When calculating deficits, they will no longer include increases in research and development expenditure or the costs of structural reforms, particularly of revamping pension systems. They also have exempted the costs of combating natural disasters and other external shocks – such as terrorist attacks – from inclusion in budget deficits. In fact, Germany has even managed to have the costs of its reunification moved off budget. Since this has made it possible for governments to do a better job of including their priorities in their budgets, the decision will have a fundamental influence on the future of PPPs.

When ESA 95 was designed, no separate rule was included on accounting for PPPs, and for a long time this configuration was left completely unregulated. In February 2004, Eurostat issued a directive that established the guidelines for the national economic accounting of PPPs. The directive sets risk allocation as the main consideration. This means that a facility built within a PPP project qualifies as outside the public sector if the private company bears the *construction risk* and the asset *availability risk* or the *demand risk*. Therefore, if the government bears the construction risk or the private company bears only the construction risk, the asset qualifies as a government project and its input costs have a negative impact on two Maastricht indicators: it deteriorates the budget balance and increases the national debt since it counts as credit provided by a private company.

The financial configuration allowed in a PPP gives the government a greater degree of freedom, and two extremely different arguments for and against their use.

For

- PPPs make supplementary investments possible, which in turn promote economic growth.
- PPPs were used before Maastricht, suggesting that responsible and long-term thinking are compatible with one another.
- PPPs support the timely appearance of economies of scale, helping to expand thought processes beyond single government terms of office.
- With PPPs, the Maastricht deficit index includes only the portion of an investment paid out in the given year, so the PPP barely increases the national debt.

Against

- The PPP configuration lets government fantasies run rampant in attempt to chalk up the short-term benefits of projects that subsequent administrations will spend the next 20-25 years paying off.

- Before Maastricht, very few governments dared to take the responsibility for the long-term decisions required by PPPs, and even the ones that did kept these projects under tight wraps.
- PPPs are good for maximizing profits on short term, which on more than one occasion has meant ignoring future needs. Original contracts require extensive review before new demands linked to new technologies could be met.
- Unlimited use of PPPs contradicts the Maastricht principle, which requires holding the budget deficit within 3 percent of GDP. They are an enticement for future abuse. A growing number of countries trying to overcome budget problems have been choosing PPPs, through which they can sidestep the politically unpopular measures really needed by the economy.

If, rather than shifting certain items off budget on long term to keep them from increasing deficits, member countries manage to reach agreements, – conceived principally in conformity with the Lisbon goals – the currently rising popularity of the PPP configuration in Europe, would decline. If they are not, and this is the more likely scenario, the PPP financial configuration faces a bright future. We have already seen a rise in investments in Europe that utilized this structure. One sign of its growing popularity is that Germany signed its first PPP motorway construction project in March of 2005. (In each of the past few years, Germany's public finance deficit has exceeded the Maastricht level).

From the finances point of view, exceeding the Maastricht 3 percent deficit – a figure that is not supported by any rational argument, by the way – is a greater risk to the country's creditors, and thus costs the country additional money in higher interest rates. Higher interest rates mean a higher debt service outlay.

At this time, the value of PPP investments in Europe has passed the EUR 250 billion mark. The United Kingdom is the largest single user of PPPs. The regulations they employ are very advanced, thanks to their historical roots. Many electric and water utility systems were built in nineteenth century in England. On long term, they served to link up the private sector to the public one, including both the central and local administrations. This begs the question of what kinds of legal conditions and financial transparency can attract private investors when making public procurements. In other words, the PPP has become a new form of public procurement. It has become a specific form of the competitive procedure.

THE LEGISLATION BEHIND PPP PROJECTS IN HUNGARY

What Considered PPP by Law?

There is no national legislation focused exclusively on PPPs. The practical sphere has galloped ahead of the legislative one in this area. Surely catching up legally would provide more transparency and predictability for investor and government alike. At the same time, regulations might not simply increase predictability since they might also contain too many restrictions, precisely because of the diversity of the PPP construct. There have been examples for both separate PPP laws and coordination of various laws within the international arena.

Hungary has no legally distinct PPP category. Legislators only refer to it or describe the phenomenon. The economic concept of the PPP has not yet become a legal category.

The Regulatory Framework

Hungarian PPP regulation rests mainly on Act CXXIX of 2003 related to public procurement, and on Act XVI of 1991 on outsourcing as well as on the Civil Code and certain tax laws. The EU has a wealth of legal material on regulatory issues, of which several major ones deserve mentioning.

- Council Directive of July 26, 1971 on public procurement contracts for con-

struction projects regarding the termination of restrictions on the freedom to provide services and on granting contracts to public procurement bidders for construction projects who submit offers through representative offices or branch offices;

- Council Directive 92/50/EEC on the harmonization of public procurement procedures when ordering services;
- Council Directive 93/36/EEC on the harmonization of public procurement procedures when ordering products;
- Council Directive 93/37/EEC on the harmonization of public procurement procedures for construction investments;
- European Parliament and Council Directive 97/52/EC on amending directives 92/50/EEC, 93/36/EEC, and 93/37/EEC;
- Council Directive 89/665/EEC on the harmonization of laws, decrees and public administration ordinances regulating the application or legal remedies related to public procurement procedures for product procurement and construction investments;
- Council Directive 93/38/EEC on harmonizing procurement procedures for organizations within the water utilities, energy, transportation, and telecommunications sectors;
- European Parliament and Council Directive 98/4/EC amending Directive 93/38/EEC;
- Council Directive 92/13/EEC on harmonizing the laws, decrees and public administration ordinances regulating community rules on public procurements within the water utilities, energy, transportation, and telecommunications sectors.

The common principles of EU regulations are transparency, equal access, and fair competition. This is true not only for PPPs, but also for all public procurement and government investments. Transparency, as a pervasive principle, is intended to reduce the flowering of the reprehensible aspects of bureaucracy, and to target the establishment of an EU that is closer to the people and easier to monitor. With PPP projects, this is best employed in the bidding process. Equal access is designed principally to assure that businesses from different member nations have equal chances to participate.

In keeping with the Treaty of Rome, the free movement of people, capital, and services must be fully adhered to in PPP projects. Before that, giving priority to domestic businesses/investors has not been prohibited. In the resulting keener competition, the national SME sector is given some protection by the requirement that the winning bidder must use subcontractors, demanding that subcontractors be chosen according to a specific percentage scale.

These regulations were behind the Public Procurement Act passed by Parliament in 2003, which is an attempt to coordinate the above principles.

The law – by definition – is to be applied to all PPP projects. The applicability of the law is more extensive than previous legislation had been, but it does not affect the PPPs, since they had been within the scope of mandatory public procurement even before the law was passed. Procedures differ depending on the value of the investments. The law calls for separate public procurement procedures for projects that reach the community value threshold, for projects between the national and the community value thresholds, and for ones that are below the national value threshold.

Data Protection Issues

It is important to mention a few words on the public nature of PPP. These agreements are of strategic importance and may influence the lives of generations, not to mention the fact that the public monies used (and earmarked) are in the billions. Therefore, it may be very much in the interests of economic players and citizens to learn the content of these private contracts with the central or local governments.

Act LXIII of 1992 on protection of personal data and the public nature of data for public interest defines data that is accessible to all in very clear terms:

"**§ 2** In applying this Act:

4. *Data of public interest:* data managed by, or concerning the activity of a body or person that

performs central or local government tasks or other public tasks as defined by law, does not qualify as personal data;

5. *Data accessible due to public interest:* all data that does not qualify as data of public interest that is managed by or refers to any natural or legal entity, or organization that does not have a legal entity as specified by law shall be made public in the public interest;"

The law also specifies the obligation of state bodies to make information public:

"**§ 19** (1) Bodies or persons (hereinafter, together: bodies) performing state or local government tasks or other public tasks as defined by law shall be mandated to promote and assure the accurate and fast provision of information to public opinion on the issues within their scope of jurisdiction. These shall include, in particular, the state and local budgets and their implementation, the management of state and local government assets, the use of public monies and associated contracts, and the provision of special or exclusive rights for market players including private organizations and persons.

(2) The bodies noted in Section (1) shall publish or otherwise make accessible the most important data concerning their activities – in particular, regarding the evaluations of their authorities, jurisdiction, organizational structures, and professional activity and the outcomes of the above, the types of data in their possession, and the legislation under which they operate and manage their finances. Unless otherwise specified by law, the names, positions or titles, and job descriptions of the persons representing these bodies in their fields of jurisdiction shall be public and accessible to all. The manner in which this information is to be provided and the circle of relevant data may be specified under separate statute.

(3) The bodies cited in Section (1) shall make it possible for all persons to access the data of public interest in their possession. Unless the data has been qualified as a state or service secret by a body authorized to do so, or if the information is qualified because of an obligation set forth in an international treaty, or if publication of the information is restricted by law as information in any of the following categories:

a) defense;

b) national security;

c) law-enforcement or crime prevention;

d) the interests of central financial or foreign exchange policy;

e) the interests of foreign relations or contacts with international organizations;

f) court proceedings.

(4) The personal data of personnel as they relate to proceedings within the authority of the bodies cited in Section (1) shall not limit access to the data of public interest.

(5) Unless otherwise specified by law, data collected for internal use and data related to decision preparations shall not be public within twenty years after they are handled. Upon request for this data, the head of the body in question may allow access within this period.

(6) The Civil Code shall have precedence with respect to accessing and making public data of public interest and accessing business secrets.

(7) Furthermore, publication of data of public interest may be restricted by European Union legislation and significant financial or economic policy interests of the European Union including monetary, budgetary and tax policy interests."

Sadly, current practices have been exactly the opposite, not allowing access to the significant points in the contracts. In my view, there is no reason for treating them as service or state secrets. On the long term, the absence of transparency and treatment of decisions as confidential information is not beneficial to either economic players or the political elite.

PPPs – PUBLIC ADMINISTRATION PROCEDURES

The ministries conduct preliminary analyses to decide which projects are worth executing within a PPP configuration. The ministry in question handles the details of elaboration as a project plan. Project plans have to contain the total of the annual projects for a given year including PPP projects underway as well as other

long-term commitments. The project plans also have to contain information on each specific project. This information consists of two parts:

- The general issues surrounding the project (goal, social impact, possibilities for execution, international examples), and
- A more detailed presentation of project specifications (time of completion, estimated costs, fee payments, central budget payments, cost breakdown).

When putting together the project plan, soliciting the opinions of two organizations is possible and worthwhile:

- One is the opinion of the bureau investigating supports, which is charged with determining whether or not the state payments to the private investors considered as state support, and
- The other is the opinion of the PPP Inter-Ministry Committee, which is important to avoid later disputes.

After this, the project draft goes before the PPP Inter-Ministry Committee. This committee is made up of delegates from the Ministry of Economics and Transport, the Finance Ministry, the Prime Minister's Office, and the Central Statistics Office, as well as from the ministry that submitted the project. The committee can propose the addition of supplementary information or amendments. Then, after the possible supplementary information or amendments have been submitted, the draft project goes to the government's economics decision-makers. If they approve the project, it goes before the cabinet. (The PPP Inter-Ministry Committee has the right to submit its opinion). If the cabinet supports the project and only then, it will authorize an invitation for tenders. There are two possible alternatives:

- If the project draft has been thoroughly elaborated and the calculations appropriately completed before it goes before the cabinet, the ministry concerned can receive permission to invite tenders without having to resubmit the project to the PPP Inter-Ministry Committee.
- If the project draft has not been thoroughly elaborated and the calculations are considered inappropriate when the project goes before the cabinet, the call for tenders will have to be submitted through the Inter-Ministry Committee. In this case, the initial calculations will have to be revamped to make them more specific.

There are two possible outcomes to the tendering process:

- The value of the bids may exceed the value that had been preliminarily calculated. In this case, the ministry may declare the bidding process invalid. (It is not necessary).
- The value of the bids does not exceed the value that had been preliminarily calculated.

In either case, the contract takes effect after governmental approval. If the project exceeds HUF 50 billion in value, the approval of Parliament is needed.

The PPP Inter-Ministry Committee and the Hungarian State Treasury must be notified of the amount of funding required, the way it is to be phased, and the payment framework, as soon as the contract goes into effect.

During the life of the project, the organization responsible for it must brief the PPP Inter-Ministry Committee annually. The committee will then prepare an annual report on the status of the project on the basis of the briefing.

EXPERIENCES IN HUNGARY

The idea of introducing PPPs in Hungary came up in the early 2000's, as it did in many other countries. The motorways that were outsourced for construction in the early 1990's might be considered predecessors to PPPs, but were not deliberate PPP-type projects. Both parties, the government and the private sector, contended with unpredictable economic circumstances and risks when contracting for this project. (It would not be wise to exclude these projects when drawing conclusions on lessons learned, even though there were only quasi-PPPs). The first specifically PPP project took place more than ten years after the regime change. When the contract for the Budapest Sports Arena was signed, political risks had been minimized, the economy had

been transformed, and major macroeconomic indices were in equilibrium.

Then, circumstances changed fundamentally between 2000 and 2004. The number of PPP projects increased quite significantly starting in 2004.

The role of the state has grown constantly in recent years and it is still growing. This means that both the revenue centralization rate and the redistribution rate are growing. There have been no adjustments since 2002. In addition, by the end of 2002 a significant public finance deficit coupled with a high current account deficit had evolved. As measures to combat the problem were not taken, the government chose to use PPPs to implement its projects. The situation is similar to the ones in several Western European countries insofar as the Hungarian government was also unable to create the conditions for economic growth combined with a cut in expenditure.

While decisions to go ahead with PPP projects in 2000 had been taken against a background of favorable macroeconomic conditions, in 2004, the PPP projects were initiated because the administration had failed to reduce expenditure and had continued its policy of distribution. Now, let us look at the arguments given to support the various decisions from the theoretical point of view.

Regarding the PPP financing configuration, the state concludes an agreement with the private partner, knowing that:

- The benefit will be reaped on short term
  - For only in exceptional cases will the government concluding the agreement be responsible for meeting it on long term (since the agreement will run through five or six terms of government, which will rarely be the same administration) – *government outlook,*
  - For only in exceptional cases will one and the same minister be responsible for meeting it on long term (since the agreement will run through five or six terms of government, and the post will rarely be held by the same minister) – *sector outlook,*
- It will operate well if the bidders are sufficient in number to allow market mechanisms to regulate the process, and
- The promises of the political administration will be binding and it will be forced to produce the promised results.

The private partner concludes the agreement with the government knowing that:

- The government may not necessarily have an interest in coordinating short and long-term goals, so that their balance between short and long-term goals might be upset. This is true for both the government and the specific sector. The private sector always focuses on the whole venture (the long term) when ascertaining the success of the venture, and will not be detoured by short-term advantages while neglecting its long-term interests;
- Market mechanisms can be distorted (in cases of a monopoly or near-monopoly) conditions;
- A rational venture conflicts with business and political interests. On the government side, the political interests inherent in winning reelection, this may cancel out business interests.

Additional categories are also possible with respect to time lines, government players, and the subject of the contract.

Often, cooperation projects between public and private sectors for 3-5 years duration are common in terms of *timeliness.* This is an intermediate configuration, which dulls the advantages and disadvantages of a PPP project, taken in the strict sense of the term. The size of supplementary investments will be significantly lower than the amount needed for a PPP project, the government's sense of responsibility will increase, and the advantage to the government from economies of scale will decline. There have been already a number of such projects in Hungary and elsewhere in the world, but this type of cooperation is not a PPP project in the strict sense of the term. Therefore, I will not focus on this three to five-year configuration at this time.

Further differentiation among *the government players* is expedient, because of the effects

of a PPP project on the national economy will be significantly influenced by whether the project involves the central or a local government. The various projects might be too high in ratio compared to local government budgets, but – with the exception of the city of Budapest – they will not really weigh down the national economy. Of course, the overall debt undertaken by the local governments can become significant on national economic level as well. (Later, I will return to ways of optimizing the debt amount).

If the cooperation fails, it matters a great deal, whether it had been a local or central government PPP venture. In principle, the central government should be able to handle the financial repercussions of a bad deal. The local government – with their limited resources – will have to seek outside help (from the central government or credit) to manage the same. This will be the only way it can maintain to a contract with a private business.

As far as the *subject of the contract* is concerned, the defining point is whether the state offers the private business a monopoly (or near-monopoly) status in the contract or simply a service for which it must compete on the market. If the private firm is offered a monopoly (or near-monopoly) status, the government can serve as a medium and operate various market features if it has an appropriate share in the ownership of the company with the monopoly, and/or if it introduces tight regulations (price, a public service that should be provided to all, etc.). Government regulation is particularly important in sectors that are sensitive to new technologies and to demands for new technologies. Although they are more risky on the long term (require higher installments to the bank), in order for private investors to increase efficiency, they have to withstand the administrative costs of excessive government control to provide the service on at least the same level – which in their own interests, has to be income-producing. Transferring a monopoly requires the highest level of attention, the greatest care, and the most caution from the public and private sectors. On the long term, competition on the market will provide efficient services and reduce the role of the state. The regulation, however, remains in government hands. In either case, the private business becomes profitable by offering more efficient public services than before.

PPP projects cannot be utilized infinitely; their overall value has to be in sink with budget limitations. This is a true hazard to the PPP configuration. It is not recommended that the central budget or the specific sectors exceed a certain level of spending on this type of project. It is necessary to set the spending level in advance, because this helps the government and the specific sectors to keep spending under control. It is important that both set their limits, because this enables the given government to choose its priorities. It also makes it possible for the central government to keep its PPP project outlay in hand.

ESTABLISHING PPPs – OPPORTUNITIES AND/OR LIMITATIONS OF THE CONFIGURATION

When evaluating the PPP structure, the first thing to look at is the costs and benefits that are reasonable. In my view, often the theoretical debates tend to make us forget to look at the concrete ideas promoting practical implementation or to conduct a detailed investigation of specific domestic circumstances. At this time, the issue for debate is not whether we need this method or not. The real questions are: why do we lack the fundamental legislative framework; and what specific areas would it be expedient to open to PPPs. It is not a good idea to set up individual public procurement as a framework rule, rather, what needs to be considered are the programs already completed programs. It is essential to expose conflicts of interests, which can have unique aspects based on industry, sector, and region alike.

We could treat PPPs like resource optimization programs, and use them only if certain pre-determined conditions are met. When a commission is given to a private investor, it

could include a variety of activities such as planning, execution, operation and financing, and in some cases, even outsourcing. A wide variety of factors could trigger the outsourcing of government tasks. They include insufficient resources or capacities, a lack of professional aptitude, less willingness to take risks, less ability to compete with services offered by the market, shortage of capital, or even tax factors (such as the reimbursement of the value added tax). PPPs make it possible to break down the payment configuration into small chunks as opposed to accounting for a single, large amount when major investments are undertaken.

Effective economic operation on the part of the private sector can contribute to meeting a variety of social demands in a responsible manner. A long-term commitment – lasting through multiple terms of government – could make project financing more stable and predictable, and the implementation more flexible. Extensive guarantees will ensure that the assets resulting from the investments will be utilized efficiently throughout their entire life cycles. For instance, this will prevent a facility, network, or support system from becoming disused or ownerless.

Costs, risks, and responsibilities are shared based on reciprocity. Project implementation strategies tell us whether a PPP configuration could be used effectively for a given project. The most important factors are the selection of the type of contract, and the manner of financial accounting. Less complex projects involving only short-term effects could result in insufficient use of resources or wastefulness within the framework of a PPP.

The principle of sharing risk and responsibility involves the practical danger that neither partner may be willing to accept the risks triggered by uncertainties. Therefore, suitable preparations have to be made to manage conflicts and the problems spawned by complicated legal disputes.

When financing projects for public purposes, one has to count with the professional market outlook when introducing private capital. The opportunities inherent in and the limits of business management tools are well known, so more attention has to be paid to the quality criteria of providing the services. As social demand grows extensively, the state has to compete, so that residents become increasingly satisfied with the services offered by the public sector. Thanks to the spread of a "consumer-friendly" outlook, all citizens will feel better if they have to manage some official business.

The PPP is one means of expanding the infrastructure and as such, it is suitable for speeding up the investment processes. However, in a given country, speeding up infrastructural development could result in revitalizing the entire national economy. In an optimum case, the state's share of resources associated with a PPP should be predictable regarding both duration and amount, since during the contracting period the state will be required to pay a regular service fee that does not change from one payment to the next, therefore it could be planned. With traditional government investments, investment costs have to be covered first, followed by operational costs, and the costs of maintenance and overhead. With a PPP on the other hand, public finances will not have to supply any funding until the project has been completed. Only afterwards, when a set service fee have to be paid according to a predetermined schedule.

Inflows from the operation of the project can affect accounting. If it chooses, the government can agree to receive a lower share than it might otherwise be entitled to, or even give up all its proceeds, in exchange for a reduction in the set fee it pays for the service. At any rate, the government will own the facilities after their completion, and since they will serve the public, it would be wise to cover a portion of the operational costs of the service from government funds, so that low-income residents could access these services as well. The state is responsible for monitoring the implementation of the public service specified in the contract. It should specifically focus on whether or not performance requirements are being met. In this area, two serious problems could occur. One is

related to mistakes made during the establishment of original performance requirements, which is very costly to modify. The other occurs when the partner does not meet the responsibilities it undertook in the contract, blaming special conditions for the non-delivery.

If contract conditions for the given public service are set in advance (this includes a complex system of performance requirements), inflexibility could hinder the attempt to adjust to changing regulations that are unpredictable in advance, which could upset the existing financial accounting system as well. The only way this could be prevented is if the state accepts a certain level of risk, which of course, shifts some of the responsibility back to the government. A general principle is that the entity taking the risk should be the one that has a stronger influence on efforts to offset it. For instance, the private investor should accept responsibility for hidden flaws, because it is responsible for the quality of planning and execution. Adherence to deadlines and keeping up with the budget are also the private partner's risk. The government, however, is responsible for the risk of non-general and foreseeable legislative changes that could be disadvantageous to the investor. Risks related to unforeseen events *(vis maior)* are dependent on their nature, but generally these are shared by the state and the private investor. The risk of public resistance is a phenomenon that is more common lately, and the costs associated with this risk have to be shared in a similar manner.

There can be three participants in a PPP project, and all three could share the financial risks. In addition to the executor of the investment and the banks providing the loan, the state will also have to give a guarantee of precise adherence to payment obligations. From the point of view of financing, the private sector mainly tends to play the role of a mediator. Since it has appropriate collateral and is creditworthy, it will be able to access significant bank loans to finance the project and its operations. At the same time, the state will pay the private firm the amount agreed to in the contract. One portion of this amount goes back to the credit provider as loan repayment and interest, while the remaining portion will be used to finance operations, distribute in a form of profits, and to reinvest. A high level of capitalization is needed to participate in a PPP, and the rate of return is long term (which is equivalent to stable revenue that can be realized on a long term). Less well-capitalized firms could join the project as subcontractors.

THE FUTURE OF PPPs AND ASPECTS OF ADAPTING INTERNATIONAL EXPERIENCES

Projects that based on cooperation between the government and the private sector are not new in Hungary. To cite just a few examples: such projects include the Budapest Sports Arena, the Millennium City Center, and Motorway M5. However, these ventures differ from PPPs in that in several cases the state has bailed out private sector companies that incurred losses for which they themselves were to blame. To attain more efficient financing, a far more consistent behavior is needed when sharing risks. One portion includes a mandatory public procurement procedure, in which the appropriate offer should be chosen in accordance with a predefined and measurable system of performance requirements. Investors that incur losses should not be allowed to shift their responsibility and costs to the future users of the facility, which are the taxpayers.

In the future, the way to gauge the effectiveness of PPP projects is for the government to conduct a similar investment on its own as well as within a PPP. The costs of implementation and operation will yield explicit information on which method is more effective. Although, there had been examples for this in Western Europe, they did not occur in Hungary yet. For example, prison operations in the U.K. could provide basic information on such projects. In this case, the general cost decline is an argument in favor of PPPs. Most likely, this is the reason why the first examples for PPP projects had been prisons in Hungary as well.

INSTEAD OF CONCLUSION…

PPPs are not miracle-workers. They are just a possible solution that could be utilized by the state to execute large amounts of high-cost, but necessary infrastructural developments. Special attention has to be given to the transparency and accountability of the projects as well as a competitive environment needs to be assured. Unless the initiator of the PPP prepares carefully and defines the areas of responsibility clearly, the outcome is almost certain to be a failure.

For the players in the private sector (banks financing the project as well as the operating company) the main advantage of a PPP configuration is that it is a long term and typically a huge project with the government standing behind it. However, under current conditions, mutual dependency is not typical. The reason for this is that – besides a few exceptions – the PPP projects that are already completed or currently underway have been poorly prepared, they are not transparent, and they were motivated principally by short-term budget constraints despite of their identified long-term advantages.

If appropriate regulations are enacted, the PPP configuration could become an increasingly important area of local government investments. The risks of PPPs may be even higher among local governments, which do not have the professional knowledge and practical experience to offset these; therefore, I believe it is important to establish a more circumspect regulatory environment. Despite a high level of interest, there have been few practical examples of this type of project involving local governments. The reasons for this are the lack of thorough knowledge of the configuration, and uncertainties related to local government financing that makes it difficult to plan for the long term.

Te following state tools could assist various government bodies to finalize agreements that benefit them on the long term, and effectively utilize the needed resources for appropriate preparations:

- Revisiting the regulatory environment;
- Eliminating uncertainties in the legislative environment;
- Clarifying the relationship of related legislation (outsourcing, public procurement act) specific to the area;
- Establishing the mandatory rules that guarantee the transparency of PPP projects, designing sample contracts, etc.;
- Establishing a central PPP institution,
  - which collects, processes, and makes available the theoretical and practical information on the subject and the experiences of realized projects,
  - where the representative of the state body planning the project could request advice on project preparation, contracting, or project implementation from the subject matter experts;
- Establishing pre-conditions, which must be met before any PPP contract is signed, where
  - a detailed project plan must be submitted to the PPP institution,
  - the advantages and disadvantages of the project are identified and quantified,
  - it is demonstrated that the configuration designed is a more favorable alternative than a purely government configuration,
  - experts from the PPP institution approve the calculations, evaluation, and support the project on that basis,
  - where experts from the PPP institution make proposals, which are included in the configuration at the largest extent possible.

BRIEF CASE STUDIES

The M5 – Case Study

1. Project goal Construction of a segment of the No. IV. Pan-European traffic corridor (Berlin-Istanbul), running between Budapest and Röszke.
2. Project size The original business plan calculated about 370 million ECU.[2]
3. Reason for using PPP configuration The principal reason was to bring-in capital to build a motorway that requires significant investment, and to take advantage of international experience in operating a motorway.
4. Project duration, length of contract The concession/outsourcing contract was for 35 years. The contract was signed in May of 1994, but it only went into effect at the end of 1995 with an agreement on support for financing and operations.
5. Project players and their roles AKA Rt. was the private sector participant. Its two main owners were Bouyges S.A. of France and Bau Holding AG of Austria. Magyar Intertoll Rt., a South African owned company, was responsible for operations and maintenance. In addition to an income guarantee, the state undertook the design of the project, and procurement of construction and environment permits. It also took responsibility for acquiring the land, the existing roads and infrastructures, and reducing traffic on neighboring (competing) roads. Most of the project was covered with an EBRD loan, one portion coming directly from the EBRD and another (the larger share) coming indirectly, through international finance institutes.
6. What risks were shared during the project and how? Income risk: should incomes be lower than planned, the state guaranteed a minimum income for the first 6.5 years (until 2006). The government risk ceiling was set at HUF 9 billion based on 1993 prices.[3] Profit sharing: with estimated traffic, the state supposed to receive one-third of the paid dividends. All other investment, operational, and financial risk was covered by AKA Rt.
7. How was the service price calculated? The initial fee for motorway use was set as HUF 5/kilometer based on 1993 prices, which AKA was authorized to increase to compensate for inflation.[4] It was also agreed to offer concessions to local residents and regular users.
8. What type of contract was this? An outsourcing/concession agreement.
9. Lessons Learned (advantages, disadvantages) Purchasing power of motorway users was miscalculated at the beginning. The state income guarantee assured the viability of the venture, but resulted in poor incentives: AKA refused to cut motorway usage fees, even when it became obvious that at the given price level motorists were avoiding the motorway. Although, considering demand flexibility, a decline in fees would have cut losses. The international experience of the winning consortium regarding motorway fees did not match the situation in Hungary. The outbreak of war in former Yugoslavia strongly reduced traffic.

The Berlin Wasser – Case Study

1. Project Goal To operate 11 waterworks and 7 sewage treatment facilities to meet the demands of 3 million consumers in Berlin, increasing efficiency and attracting outside resources.
2. Project Size EUR 250 million in investment until 2009.
3. Reason for using PPP configuration To evolve more effective management and attract additional resources.
4. Project duration, length of contract Berlin Wasser Holding AG, established in 1999, agreed to conduct the maintenance operations for an indefinite period, to complete the investments by 2009, and to retain the work- force until 2014.
5. Project players and their roles Following the transformation and partial privatization of the East German Berlin Wasserbetriebe, 50.1 percent remained in the ownership of the city of Berlin and 49.9 percent was transferred to a consortium made up of RWE Aqua GmbH, Allianz Capital Partners GmbH, and Veolia Deutschland. The participants were chosen from bidders who came from all over Europe. The role of Berlin Wasser Holding AG is to provide water and sewage treatment to Berlin for an indefinite period, for which it pays EUR 68 million/year as a concession fee. The EIB granted EUR 420 million in credit for the project.
6. What risks were shared during the project and how? The private sector is carrying almost all of the risk.
7. How was the service price calculated? Initially, the cost was defined in the contract at the start of the project and is being increased according to inflation.
8. What type of contract was this? Joint venture, concession/outsourcing.
9. Lessons Learned (advantages, disadvantages) The contract is pioneering in the sense that it combines the advantages of the joint venture and the outsourced project. Inclusion of the private sector provides the inflow of the capital needed to update the water network and to streamline the operation of the company. Beyond private sector interests, the configuration has adhered to environmental considerations and to the demands of users and employees alike. The company was not permitted to increase the price of its services or to dismiss employees.
10. Other information on the project Since the private sector carried a disproportionate share of the financial risk (the investment obligation, the 9 percent interest on credit, and an annual concession fee of EUR 68 million) and it was limited by welfare considerations, it found itself facing liquidity problems, which forced an amendment to the contract. Under an agreement reached in 2004, the city of Berlin and Berlin Wasser Holding agreed to raise water rates by 30 percent. This was not a disproportionate burden on consumers, since prior to the increase the service provider had cut rates several times as required by its contract. The EUR 361 million deficit that had been accumulated, was divided between the government and the private players. With further streamlining and reduction of work hours, the company's financial situation was stabilized without having to resort to layoffs. Since then, Berlin Wasser Holding AG has appeared on the Hungarian, Croatian, Polish, Russian, and Chinese markets.

Budapest Sports Arena – Case Study

1. Project Goal To replace the Budapest Sports Hall.
2. Project Size HUF 40 billion.
3. Reason for using PPP configuration Belief in the efficiency of private capital.
4. Project duration, length of contract 20-year lease; building completed in 2003.
5. Project players and their roles Bouygues Hungaria Kft., signed a contract that includes construction, maintenance, operation and sub-leasing.
6. What risks were shared during the project and how? Private sector bore construction risks.
7. How was the service price calculated? The state agreed to pay the private corporation an availability fee of HUF 3.8 billion for 12 years, and the state also receive a certain number of days to use the arena free of charge.
8. What type of contract was this? Hybrid contract including leasing.
9. Lessons Learned (advantages, disadvantages) A significant element of the project is that the low-cost envisioned was not achieved and the contract was amended significantly.
10. Other information on the project The original contract for the Arena was concluded in August of 2001, and set the cost of reconstruction at HUF 20 billion. In the meantime, the state granted the French company handling the project another project valued at HUF 7 billion. In it, Bouygues agreed to landscape the area around the sports arena, that is, to establish a 30,000 square meter public space around it – to include restaurants, a ticket office, and a sports museum – as well as a new long-distance bus depot and a parking lot with 1,200 spaces. With that and the interest costs on 12 years of payments, the final cost of the arena – calculated with fluctuating exchange rates and interest rates – was up to HUF 40 billion. One clause in the contract states that until January of 2013 no indoor sports arena, that can hold more than 7,000 spectators, may be built in Budapest. Ninety percent of the construction was financed by bank credit, 4 percent by budget funds, and only 6 percent by private capital.

NOTES

1 Source: http://www.gkm.hu/

2 Source: EC: Resource Book on PPP Case Studies (2004)

3 Source: EC: Resource Book on PPP Case Studies (2004)

4 In addition to the inflation, the fee was also allowed to increase by the forint devaluation exceeding the difference between the credit borrowed in foreign currency and the inflation of the forint.