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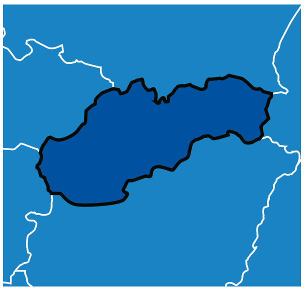

Progress to date, market needs and implications for financial instruments

The Slovak mezzanine loan to a PPP for the Bratislava ring road

Case study

European Commission

European Investment Bank
The EU bank

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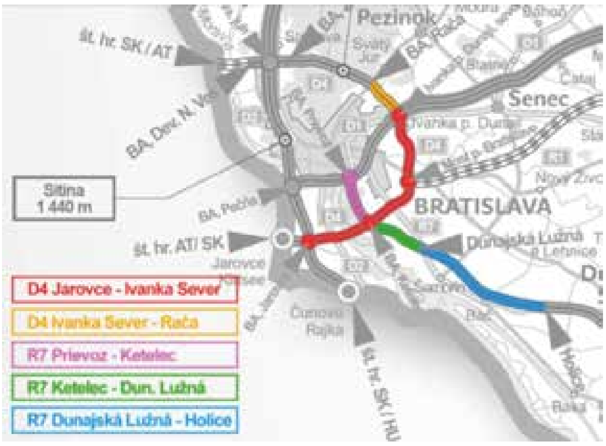
Abbreviations

Abbreviation	Full name
CF	Cohesion Fund
DBFM	Designing, building, financing and maintaining
EBRD	European Bank for Reconstruction and Development
EC	European Commission
EFSI	European Fund for Strategic Investments
EIB	European Investment Bank
EPEC	European PPP Expertise Centre
ESA 2010	European System of Accounts 2010
ESIF	European Structural and Investment Funds
FoF	Fund of funds
ICO	Instituto de Credito Oficial
MoT	Ministry of Transport
NDF	National Development Fund
NPBIs	National Promotional Bank and Institutions
OP	Operational Programme
PPP(s)	Public-Private Partnership(s)
SIH	Slovak Investment Holding
SMEs	Small and Medium-sized Enterprises
SPV	Special Purpose Vehicle
SZRB AM	Slovenská záručná a rozvojová banka Asset Management, Slovak Asset Management Company
TA	Technical assistance
TEN-T	Trans-European Transport Network
UDT	Urban Development and Transport

In June 2016, the finance contracts of the Public-Private Partnership (PPP) for the Bratislava bypass ring road called D4R7 (the road is illustrated in the figure below) were signed between the Ministry of Transport and Construction of the Slovak Republic (MoT) and the private party. Part of this EUR 989 million PPP is financed through a Cohesion Fund (CF) supported financial instrument which is providing a mezzanine loan into the scheme. The mezzanine loan is being provided by the Slovak Investment Holding (SIH), using EUR 28 million of CF funding originating from the 2014-2020 'Integrated Infrastructure' Operational Programme (OP). Furthermore, the case study shows how European Structural and Investment Funds (ESIF) financial instruments and European Fund for Strategic Investments (EFSI) resources can be combined at project level.

This case study illustrates how PPPs can provide a viable delivery route for financial instruments, especially in the 'Urban Development and Transport' (UDT) sector.

Figure 1: The Bratislava bypass D4R7 ring road financed by the PPP partly supported by a Cohesion Fund (CF) financial instrument



Source: Ministry of Transport and Construction of the Slovak Republic, 2016.

1. Description of the financial instrument

1.1 Rationale and objectives

SIH was established on 1 May 2014 to implement, among others, financial instruments under ESIF. It acts as the manager of legacy resources from the 2007-2013 programming period, bundled together in the National Development Fund I (NDF I) and as manager of the National Development Fund II (NDF II) for ESIF resources from 2014-2020 programming period. Financial resources allocated to NDF II 2017 amount to EUR 623 million. Its investment strategy is based on OPs from which funds were invested into NDF II and on Funding Agreements between the managing authorities/intermediate bodies and SIH. NDF II's main objective is to improve access to financing for projects and institutions that are active in the following areas: transport infrastructure, energy efficiency, waste management, social economy and Small and Medium-sized Enterprises (SMEs). Depending on the sector, NDF II is either investing directly into the final recipient or via financial intermediaries.

The D4R7 PPP project involves designing, building, financing and maintaining (DBFM) 27km of the D4 motorway that will connect to the 32km R7 expressway, thus forming a bypass ring road around Bratislava. The D4R7 is an availability payment-based PPP, meaning there will be no user toll charged and the private partner will be paid for the availability of the road at a predefined quality, with a concession period of 30 years. It has been classified by the Slovak government as a national priority in supporting economic growth and social cohesion, by providing a new high-capacity bypass route around Bratislava to help ease current congestion on the existing road network. The D4 motorway is also part of the Trans-European Transport Network (TEN-T). The R7 segment of the project is not part of the TEN-T network. Finally, the D4R7 connection was not listed as a major project in the 'Integrated Infrastructure' OP, meaning in case of grant financing to a project the total eligible cost cannot exceed EUR 75 million.

From the public sector, MoT is the project promoter, procuring the PPP, and SIH provides the mezzanine loan supported by CF to the scheme. It is worth noting that SIH is a specialised fund of funds (FoF) managed by SZRB Asset Management (SZRB AM, the asset management entity of the Slovak Guarantee and Development Bank)[1]. SIH was established by the Slovak authorities to implement ESIF-supported financial instruments in the country. From the private sector, a call for tenders was awarded to a Special Purpose Vehicle (SPV), a consortium comprised of Macquarie Capital, Cintra Infraestructuras Internacional SL and PORR AG. These companies are responsible for the design, construction, operation, and financing of the motorway. Prior to the contract award, the SPV secured financing in the form of senior debt, most of which was provided by the European Investment Bank (EIB) supported by the EFSI guarantee.

In terms of timeline of the PPP:

- The environmental impact and strategic environmental assessments of the D4 highway were finalised in 2012;
- The tender notice for the PPP feasibility study was published in April 2014; the study was finalised in October 2014 and published in January 2015;
- The invitation to tender was published in January 2015 and the selection of the preferred bidder was finalised in January 2016;
- The concession contract (with commercial closes) was signed in May 2016, and
- The finance contracts of the PPP were signed in June 2016.

1.2 Scope

The scope of the financial instrument set up by SIH is to provide debt financing to projects in the transport sector. The first operation was a mezzanine loan to the PPP in view to finance the D4R7 ring road around Bratislava.

1.3 2014-2020 Operational Programme

The EUR 28 million of the instrument is from CF resources originating from the 'Integrated Infrastructure' OP of Slovakia.

1 In 2018, the fund manager SZRB AM was renamed Slovak Investment Holding (SIH) and the fund of funds (FoF) was renamed National Development Fund II (NDF II).

1.4 Financial allocation and governance

The PPP combines several sources of funding:

Cohesion Fund funding provided as a mezzanine loan

SIH uses CF resources to provide a mezzanine loan to the SPV created for the project. This subordinated loan is senior to equity and shareholder loans, provided by the members of the winning consortium but junior to senior debt provided by banks. Due to the full subordination of this mezzanine loan to the senior debt, it is treated by senior lenders as equity replacement. Consequently, the CF supported financial instrument helps reduce the private sector's cost of capital (as the CF resources carry no funding costs, the mezzanine loan may be priced cheaper than commercial sources of equity, where needed). According to the Slovak authorities (i.e. the Antimonopoly Office of the Slovak Republic) there is no State aid involved in this project.

The total amount NDF II had available from the OP for transport sector projects is limited to EUR 50 million. SIH has limited its investment in the EUR 989 million project to EUR 28 million supported by CF, as a higher contribution would have reduced the equity of EUR 87 million too much compared to the amount of debt. The mezzanine loan is provided for a 33 year period at a fixed rate.

The opportunity to inject CF funding into the PPP was discussed with bidders during the initial tender stage which enabled all four bidders to include the financial instrument into their funding structures. The partial replacement of equity with a mezzanine loan reduced the total cost of capital significantly and this resulted in a reduction in the annual availability payments to be paid by the MoT.

In addition, in order to satisfy the concerns of sponsors and private lenders that the SIH investment might grant undue influence to the public sector, the role of the mezzanine lender is largely passive in the PPP with no voting rights, and limited step-in rights. The modest size of SIH's investment (EUR 28 million) was also a factor that gave co-investors comfort that the instrument would not impact intercreditors' normal decision making processes.

EIB's contribution was considered more beneficial on the side of senior debt as described below. Using CF resources under a financial instrument provides the following advantages to the scheme:

- If CF resources would have been deployed as a grant to the project, the total private sector financing requirement of EUR 989 million would have been reduced by EUR 28 million. This would have replaced mainly the debt as the ratio between equity and debt (the gearing) would have remained the same; while deploying CF resources as a mezzanine financial instrument (the latter replacing equity, which is the most expensive tranche of capital), reduces the equity share of the project;
- A grant is also a one-time investment. Once invested, the funding is spent and is not to be repaid; while the deployment of a financial instrument is more sustainable as the instrument is repayable, and assuming the project performs as expected, the SIH will even earn a return on its investment;
- Finally, whilst limited in scope, the financial instrument provides limited rights related to the project in which it has invested over the whole period of the concession (i.e. mainly information rights), which a grant would have not provided.

EIB's senior loan supported by the EFSI guarantee

The EIB provides a senior loan of EUR 427 million with a long maturity of 33 years, with a grace period of 5 years, to the SPV, representing 43% of the total project costs, and generating substantial additionality. These factors helped the commercial investors finance the project at an acceptable price level. In a PPP project all bidders need to secure commitments from commercial banks for the total amount of debt. Given the large size of senior debt (EUR 952 million), and the fact that each of the bidders had to obtain finance to support their bids, financing that represented four times the size of the project had to be secured. Raising this amount of project finance debt has never previously been attempted in Slovakia. In order to increase competition and achieve a reduction in construction costs it was essential that the public sector maximise the potential sources of finance for the project.

The EIB, which could offer support to all bidders, was asked to maximise its support for the project so that the bidders' financing terms would remain competitive despite the large numbers of bidders. Consequently, and in order to provide significantly larger facility sizes than what would have been made available in its standard business, EIB has sought the support from EFSI. The benefits of the financial terms of the EIB loan offered to all bidders were passed on to the public sector as the consortia reduced their bid prices during the competitive procurement process.

Commercial investors

The financing of the project was further facilitated by the involvement of another international financial institution, the European Bank for Reconstruction and Development (EBRD). The EBRD also has offered its financing to all interested bidders and it provided additional EUR 148 million senior loan. The remaining EUR 377 million of debt was provided by the Spanish national promotional bank, Instituto de Crédito Oficial (ICO) and four commercial banks, Unicredit, ČSOB, SMBC and Credit Agricole. The EBRD, ICO and the commercial banks provided floating rate loans, split into three tranches, short term (10 years), medium term (20 years) and long term (32 years).

The procurement model chosen was competitive dialogue. The procurement phase had a critical impact on reducing the costs of the project. The choice of an efficient competitive dialogue resulted in the optimisation of the project technical specifications by the bidders.

The PPP contract was designed in a way that majority of risks are with the private party, such as the DBFM risk. Some risks such as land acquisition and traffic risk remain with the public sector. This arrangement made it possible for this project to receive an ex-ante approval by Eurostat to be considered outside the government sector according to the European System of Accounts 2010 (ESA 2010). Thus the project does not increase the public debt and deficit of Slovakia which was a prerequisite for such a sizable project.

Finally, the payment from the MoT to the SPV is made through an availability-based service fee. The public side will make annual availability payments of EUR 52.8 million to the private partner, based on the availability of the road and quality criteria referring to maintenance of the road and provision of the necessary services like winter servicing. The public partner has the right to reduce the availability payments, if the SPV fails to fulfil the defined availability and quality criteria.

Regarding the design of the financial instrument, SIH, as a FoF, invested directly into the project without a financial intermediary. This allowed for fast deployment of a substantial amount ESIF financing without delays through the process of selecting financial intermediaries. This is especially useful for the investment in single large projects.

1.5 Financial products

As already mentioned, the financial product provided by SIH to the PPP using CF resources is a mezzanine loan replacing part of the equity.

2. Lessons learned

2.1 Results

The MoT mandated consultants for the feasibility study of the project, covering technical, financial and legal elements. The study was performed between September and October 2014. It recommended a PPP structure as the optimal delivery method, mainly for value for money reasons, as well as for a more efficient use of the CF resources. Also, the analysis underlined that the impact of the project on public finances over the 2015-2050 period would be lower with a PPP than with a traditional procurement route. According to the MoT, the PPP approach was also deemed to be a means to accelerate the project delivery.

A clear benefit achieved for the MoT was that the final D4R7 budget was substantially lower (about 60%) than a base case scenario estimated under the MoT feasibility study. According to the Ministry of Finance this was achieved through favourable financial market conditions in the period between bid submission and financial close, a significant appetite of the market to support this type of transaction, the participation of EIB with EFSI and SIH, technical optimisation of the project and high quality and robust competitive dialogue.

The case shows that the possibility for a FoF manager to invest directly into larger projects offers opportunities to invest into projects that are not part of a larger project pipeline. The selection of financial intermediaries for single transactions is time consuming and does not allow for sufficient flexibility.

According to the main stakeholders, the key takeaways from this project are:

- Publicly-supported financial instruments (including supported by CF) and private finance may be combined successfully within a PPP project;
- Combining ESIF and EIB resources guaranteed by EFSI in a PPP project may support Cohesion Policy projects; and
- Combining publicly-supported financial instruments with private finance can help with the affordability and bankability/finance-ability of a project, including a PPP.

2.2 Barriers and challenges

PPPs compared to traditional work contracts are perceived as more complex. Generally, PPPs need more detailed preparatory studies. Furthermore, PPPs are usually procured via negotiated procedure or competitive dialogue, which take more time and are more complex than open procedures. In the case of the D4R7, it took two years between tendering the PPP feasibility study and the start of construction. This can be considered as fast compared to other PPPs in the transport sector. Public sector actors need the right set of skills to engage with the private sector during the procurement and also during contract implementation. Procuring authorities need to build up and maintain the capacity to manage PPP contracts.

Project finance, such as PPP, requires a different set of skills than corporate finance. Many NPBIs do not have the necessary experience to engage into such financing. On the other side, the private banks or investment funds are not familiar with the specificities of ESIF financial instruments.

The financial instrument of this size (EUR 28 million) is considered a great success by all stakeholders when maximising the impact of CF funding. It shows that financial instruments can provide an added value to project financing in general and specifically to PPPs. It is not clear if this approach is replicable in smaller PPP projects. In this project, the equity replacement loan, for legal reasons, is limited to around 3% of the total capital expenditure.

2.3 Key enabling factors

Regarding the use of CF funding into the PPP:

- Since CF resources available for this project were very limited, other forms of financing (like financial instruments) had to be considered;
- The Slovak government believed that demand for the new D4R7 infrastructure would be high and attractive to private investors, and therefore appropriate for a financial instrument;
- The fiscal treatment of project expenditures (i.e. off-balance sheet financing in compliance with Eurostat regulations) was a key determinant in favour of the PPP option, because constitutional law prevents public administrations from increasing public debt above current thresholds;
- Finally, according to the views expressed by the Slovak authorities (Ministry of Finance and MoT), PPPs and projects in which financial instruments improve financing structures are viewed as complementary to projects funded by the Cohesion Policy via traditional grants.

From an EFSI perspective:

- This D4R7 PPP was the first project to benefit from the EFSI guarantee in Slovakia. Also, it is the second PPP project in the transport sector in Slovakia and it is considered a successful example of a PPP procurement;
- The combination of ESI Funds and EIB resources guaranteed by EFSI is an enabling factor for the project. The ESIF contribution allowed for a reduction of the equity related cost and the EFSI guarantee facilitated the EIB's senior loan for the whole duration of the concession. Without the EFSI guarantee it would have been difficult to secure senior debt for the 33 year period.

The PPP also benefited from technical assistance (TA) provided by the EIB. In addition to its senior loan, the EIB provided a number of technical recommendations to improve the project optimisation during its own appraisal process, as well as before and during the public procurement phase. Following a further review of the project scope, the MoT incorporated these technical recommendations in the minimum scope required by the private sector. As these discussions were held at a timely stage of the competitive bid process, the MoT was able to benefit from the expertise of the bidders, whilst achieving a full transfer of the selected risks to the private sector representatives.

The EIB also provided informal TA/expertise in the area of PPP financing and for the deployment of CF supported financial instruments. This support also included a PPP feasibility study building on the ex-ante assessment, which covered the design and implementation of ESIF-supported financial instruments via SIH in Slovakia, the provision of public sector PPP expertise, and overall capacity building to SIH. The joint European Commission (EC)-EIB TA facility JASPERS provided support for the project review process. The EIB advisory service EPEC (European PPP Expertise Centre) clarified the treatment of the PPP in government accounts with Eurostat. Finally, EIB's involvement in the project appraisal phase helped reduce the final project costs compared to the initial estimates of the feasibility study.

Also EC services have played a significant role in the whole process. For instance, they provided clarification of environmental conditions in the framework of the Environmental Impact Assessment and overcoming challenges of constructing the road partly in NATURA 2000 protected areas. Together with the EIB, it played an important role in the technical optimisation of the project and provided clarifications vis-à-vis rules applicable for financial instruments, and modifications of the OP in order to enable the project to be co-financed by NDF II.

In parallel, the MoT dedicated significant resources to make the project happen, both at a senior and at the PPP unit level. The Ministry:

- Established a project team composed of people with relevant experience (with both internal and external experts);
- Managed the relationship and the communication with public stakeholders and non-governmental organisations well with regards to the project; and
- Ensured active cooperation on the eligibility checks of the different multilateral/national development banks in the early phase of the project.

According to all stakeholders involved, the drive of the MoT was perceived as key for the implementation of this PPP project.

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