Key Factors in Financing Urban Transport Modernisation – Some Lessons from Central Europe

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ABSTRACT This paper draws on the experience of the European Bank for Reconstruction and Development (“EBRD”) in financing urban transport modernisation in Central Europe. The paper argues that funds for investment are available provided the right conditions are created. The paper examines what is required for an organisation to be considered “creditworthy”, and how to create a creditworthy entity. Once an organisation is creditworthy, financing options open up. The paper present examples of EBRD financing in Belgrade, Bucharest and Sofia, and draws some lessons from the region. Finally, the authors look forward to the likely characteristics of the next generation of urban transport projects in Central Europe.

RÉSUMÉ : La communication porte sur l'expérience de la Banque européenne pour la Reconstruction et le Développement ("BERD") dans le financement de la modernisation des transports urbains en Europe Centrale. La communication soutient que les fonds pour l'investissement sont disponibles dans la mesure où les bonnes conditions sont créées. Elle étudie ce qui est exigé pour qu’une organisation soit considérée "solvable" et comment créer une entité solvable. Une fois qu'une organisation est solvable, des options de financement se présentent. La communication présente des exemples de financement de la BERD à Belgrade, Bucarest et Sofia et tirent quelques leçons de la région. Enfin, les auteurs attendent avec impatience les caractéristiques probables de la prochaine génération de projets de transport urbain en Europe Centrale.

1 FOUNDATIONS

1.1 *The nature of money*

Many articles have been written and speeches made about how lack of investment is causing the decline of public transport. The implication is generally that if money were available, problems could be solved. This paper argues that money *is* abundant - and is available provided the right conditions are created.

Money flows towards specific applications if the conditions are right. Let us first identify the measures that need to be in place to stimulate this flow.

1.2 *Creating a revenue stream*

If an organisation desires to borrow money to invest, it must have a reliable revenue stream sufficient to cover all operating costs, repay the debt, and have some funds left in reserve. This applies to public sector administrations and transport operators, whether of public transport services or infrastructure such as parking facilities.

Since no practical way has yet been developed to charge for roads at the point of use, roads usually do not have a direct revenue stream and have traditionally been financed by their public owners. However, a road concession company may be able to raise finance where a revenue stream has been created from tolls and/or payments from a public authority.

1.3 *Revenue sources*

A transport company may have several “clients”: users who pay directly for the service they enjoy, plus one or more public authorities who compensate the company for social tariffs or services, or provide subsidies. While the split of payments between the client groups is a local political decision, it is essential that together they pay the full cost of providing the services. The combined revenue streams need to be sufficient and reliable in order to attract funds for investment (e.g. new rolling stock).

1.4 *Client and service provider functions*

Although public responsibilities for urban transport vary slightly from country to country, local authorities are generally responsible for planning the system and ensuring the delivery of services. Historically, many cities in Central Europe owned the operating assets, employed the operating staff, and ran the services themselves. As a consequence, those public authorities had to invest in equipment and infrastructure. Since a municipality may be close to its indebtedness limits, there can be advantages to political leaders if the City contracts-out services to providers who then finance operating assets off the balance sheet of the municipality.

If services are financially viable at the permitted fare, then there will be no financial charge on the municipal budget and all the financing will be external. If a City Council wishes to purchase some non-commercial services for social reasons or requires non-commercial fares for selected groups, it may do so provided it compensates the operator for this "public service obligation" (PSO). In this case, investments will still be off the City's balance sheet, but there will be budgetary implications.

The "Altmark decision" in 2003 by the European Court of Justice confirmed that the purchase of services by public authorities, according to specified criteria, does not constitute "state aid".

So, the challenge is to design an organisational structure in which a public authority and/or an operator is creditworthy – based on its various revenues - and can therefore raise finance for investment.

2 WHAT DOES "CREDITWORTHY" MEAN?

2.1 *Basic criteria*

To be creditworthy, a public authority or company needs to fulfill three basic criteria:

- the borrower must be able to run its affairs and repay the debt (including all fees and interest), while maintaining a suitable "reserve";
- all risks must have been identified and acceptable mitigation measures put in place; and
- in case of default by the borrower, the financiers must be able to get their money back (i.e. suitable "security" must be available).

As indicated above, the first requirement is to create a reliable revenue stream. Urban transport services are generally provided in a regulated market and therefore some form of licensing or contractual arrangements are usually necessary. In the case of public transport, the cornerstone will usually be a Public Service Contract (PSC). Such PSC should normally apply for at least the duration of the financing, unless the client authority is willing to offer satisfactory compensation at the end of the contract.

The next task is to ensure that the entity will be able to pay for all its operating costs and service the debt at all times under all reasonable scenarios. This is often achieved by specifying what is known as a "Debt Service Cover Ratio" (DSCR). Thus, for example, if the borrower is required to maintain a DSCR of 1.3, it means that it must at all times have 1.3 times the next debt repayment available.

Financiers will wish to be protected against things going seriously wrong and will therefore ask for "security". This may be in the form of guarantees or undertakings from the client authority, and/or pledges over company shares, equipment, receivables under the PSC, and bank accounts.

2.2 *Credit ratings & indebtedness limits*

Some cities or companies have a credit rating from an agency such as Standard & Poor's (S&P). For some financiers, these ratings are sufficient to establish the creditworthiness of a potential borrower, without additional analysis (due diligence). Credit ratings strongly influence the cost of funds.

As of January 2004, the following Central European cities have credit ratings from Standard & Poor's:

- Bulgaria: Sofia
- Croatia: Zagreb
- Czech Republic: Brno, Olomouc, Ostrava, Prague
- Hungary: Budapest
- Latvia: Riga
- Lithuania: Vilnius
- Poland: Gdansk, Krakow, Lodz, Szczecin, Wroclaw

Borrowings by public entities are usually regulated by national legislation. In Poland, for example, there are two statutory limits for municipal indebtedness: (a) outstanding debt may not exceed 60% of total revenues; and (b) debt service may not exceed 15% of total revenues.

A number of municipalities in Central Europe are close to their legal debt limits and therefore face the choice between modest borrowing for investment, or out-sourcing service provision to a creditworthy entity that may raise finance in its own right.

3 CREATING A CREDITWORTHY BORROWER

3.1 *Types of creditworthy borrower*

The "borrower" may be a public authority, a private company, a publicly-owned company, or a company with mixed ownership.

3.2 *Steps to creditworthiness*

How does a transport operator become creditworthy, attract funds and be able to invest?

First, there must be a sound legal framework. The borrower must be duly established (some public transport operators are still budgetary units of their municipal owners); and any contracts/concessions must be legally sound and enforceable.

In the case of a public authority:

- it should have sufficient "own revenues" (i.e. revenues that it controls); and
- should be able to meet certain financial ratios.

In the case of a company:

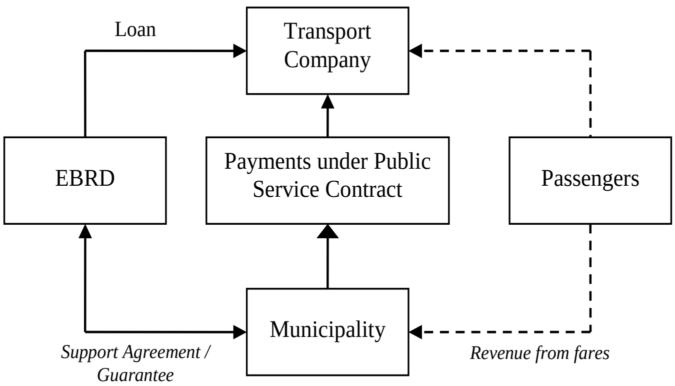
- there should be a reliable income stream based on a sound Business Plan;

- an enforceable Public Service Contract for the duration of the financing; and
- the client public authority must sign a Support or Guarantee Agreement, depending on the circumstances.

In some places, subsidies are still open-ended and untargeted; financial support for transport operations is still often subject to an annual budgeting process and political changes. Establishment of a sound PSC promotes clarity about the respective roles of client and service provider, transparency and – most importantly – opens a door to possible financing.

3.3 *Public Service Contract (PSC)*

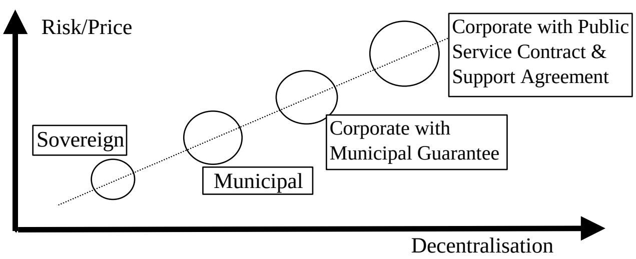
EBRD normally expects to see a sound PSC between the operator and the client authority. The PSC defines the rights and obligations of each party, including the quantity and quality of services to be provided by the company in return for service payments by the client authority. The service payments should enable the operator to invest in necessary infrastructure and equipment. The PSC may also include provisions for performance incentives and penalties. Various forms of PSC exist, notably "net", "gross" and "quality incentive" - an abundant literature is available. As illustrated in the following diagram, a PSC may apply to a public operator or a private operator.



4 FINANCING OPTIONS

4.1 *Financing options*

Once an entity is creditworthy, financing options may open up. The figure below illustrates some of the options available:



4.2 *Corporate finance*

EBRD's preference is to finance a public or private corporate entity, where feasible, to encourage management to be fully responsible for running its business. The foundations for such financing are a sound PSC and a good Business Plan.

Corporate financing may be backed by a Municipal Guarantee or a Support Agreement (with specific undertakings), depending on the situation.

4.3 *Municipal finance*

EBRD lends to municipalities without a guarantee from its central government. Proceeds may in principle be used to finance the rehabilitation of tram tracks, traffic management systems, ticketing systems, refurbishment of depots including workshop equipment, line extensions, fleet renewal and so on.

The maturity of an EBRD municipal loan depends on the life of the asset being financed, and the finance market in the particular country. The grace period usually corresponds to the time needed for project implementation. Loan margins are based on client credit risk, project risk and market pricing.

4.4 *Sovereign finance*

Central Governments may borrow to finance infrastructure that is considered of national significance. The International Financial Institutions such as the European Bank for Reconstruction and Development (EBRD), European Investment Bank (EIB) and World Bank lend to states for such strategic infrastructure.

Sometimes a Central Government will borrow at favourable rates and on-lend to local governments to improve urban transport; sometimes a Central Government will guarantee a loan to a local authority.

Although EBRD prefers to lend to the entity that is closest to the operational level, in countries where the legal framework is still relatively undeveloped, where local government financing is dependent on central government decisions, or political risk is high, EBRD will consider sovereign lending.

4.5 *Credit enhancement*

In cases where a private sector company is supplying transport services to a public authority, and where the company or its financiers perceive risks to be unacceptably high, the EBRD may be able to offer a performance guarantee, guaranteeing specific contractual obligations of a client (notably payments). This encourages private companies to enter a market, and may reduce prices because of risk reduction.

In this way, EBRD can support:

- out-sourcing of bus supply and maintenance (“contract-hire” or lease), or
- contracting out of bus-services to private operators.

4.6 *Leasing*

EBRD lends to several leasing companies that finance vehicles and construction equipment in the region. However, this activity has not yet extended to urban public transport vehicles.

5 CURRENT ORGANISATIONAL FRAMEWORK

Organisational frameworks vary from country to country and there is no single “correct” model for organising urban transport. The sharply contrasting views in the on-going debate in the European Parliament, European Commission and the industry illustrate this point. Table 1 summarises a typical situation in Central Europe today:

Table 1: Typical organisation in a Central European city

Areas	**Typical situation today**
Policy	Unclear vision regarding the development of public transport
Strategic planning	Focus on physical planning; emphasis on expanding the network
Organisational framework	Vertically integrated with city setting tariffs, specifying *and* delivering services
Tariff setting	City Council sets fares based on social situation; compensation for non-commercial services not always paid
Budgeting	Annual budget allocations; no direct reimbursement for concessionary fares
Professional expertise	With notable exceptions, low quality staff due to poor salaries and working conditions
Market forces	Generally limited application

Infrastructure will generally be the responsibility of a public authority (except in the case of a concession). Operating assets in Central Europe are generally the responsibility of the operator – whether publicly or privately owned. That operator may own, lease or rent its equipment.

6 SOME RECENT FINANCING EXAMPLES

Let us examine three case studies and try to draw some lessons from the region.

6.1 *Belgrade, Serbia*

The City of Belgrade and the EBRD signed a loan of €60 million in 2001, of which €20 million was allocated for investment in public transport. The loan was used to finance the purchase of 109 buses, bus maintenance equipment and the refurbishment of bus workshops. The Japanese and Swiss governments granted an additional €15 million in parallel.

Consultants financed through EBRD Trust Funds assisted the City to prepare a Priority Investment Programme and manage the procurement of goods. They also provided advice on restructuring the municipal transport company “GSP Belgrade”. Furthermore, the City received assistance to develop a regulatory and instructional framework for public transport. Based on the advice of consultants, the City has established a Transport Authority that is responsible for overall network planning and the tendering of bus services to private bus operators. The City also adopted a tariff policy for public transport for the next five year period.

In parallel, a Public Transport Master Plan 2005 - 2020 was developed. As a result of this Master Plan, the City commissioned consultants to carry out a detailed feasibility study for the development of a light-metro system.

Finally, a Credit Enhancement Project was initiated to enhance the City’s ability to finance infrastructure investments.

6.2 *Bucharest, Romania*

The City of Bucharest and the EBRD signed a loan of €51.5 million in April 2003 to finance the Bucharest Multi-sector Project. Part of the loan was syndicated to commercial banks.

The City is using loan proceeds to finance: (a) infrastructure improvements in Bucharest’s historic zone; (b) traffic management measures, including a modern traffic control system; and (c) modernisation of district heating facilities.

The Dutch Government has approved a grant of €2.5 million to co-finance the project. The funds will be used to expand the infrastructure improvements, and for technical co-operation to examine best value in the delivery of public transport services, and to enhance the City’s creditworthiness.

At the time of writing, the City is selecting consultants to prepare designs, manage procurement and supervise implementation.

6.3 *Sofia, Bulgaria*

EBRD signed a loan agreement in 2002 with the City of Sofia to finance the purchase of new buses and trolleybuses, and tram refurbishment. The loan amount was €35 million. In addition, a €2.5 million grant was received from the Dutch government for a new ticketing system.

Consultants provided the City with advice on the privatisation of the main workshop for tram and bus. An Environmental Action Plan was developed for all eight depots of the transport company in order to reduce pollution and improve health and safety.

The City is currently preparing an open international tender for a concession to operate around 100-150 buses in Sofia, with assistance of consultants financed through EBRD technical co-operation funds.

In parallel with the Public Transport Project, consultants financed through an EBRD trust fund are assisting the City with the preparation of a Parking Strategy and Action Plan. The City is considering outsourcing the development of new off-street parking facilities, as well as on-street parking.

7 SOME REFLECTIONS

7.1 *Commitment*

EBRD has engaged in dialogue with many municipalities and municipal companies throughout the region. There are large differences in the degree of commitment by their respective leaders.

There are many examples where EBRD has mobilised technical co-operation grant funding for a local entity to hire consultants to prepare a project, only for the investment project to "evaporate". The attrition rate for urban transport projects is relatively high. Sometimes this is because the client has a better offer of financing from elsewhere; but often it is due to difficulties in reaching political consensus locally, inexperience, reluctance to accept international procurement practice and other factors. The EBRD is ready to engage with committed clients and to mobilise the resources necessary to prepare and implement a project, but increasingly that commitment needs to be demonstrated by signing a "mandate letter" early in the process and by the client committing some of its own resources.

7.2 *Attitudes*

Just over ten years ago, public transport was seen in the region as an instrument of the state's social welfare policy. Services were nearly all provided by public operators, and rolling stock was usually allocated by a central planning organisation.

Today, as indicated above, an operator must be run on commercial lines to attract finance for investment (that is not to say that it must be privately owned or that it must make a profit).

A huge change in mentality and working practices is required to evolve from an organisation that receives an annual budgetary allocation from its client authority, at the discretion of its political masters, to one that has a multi-year Business Plan and Public Service Contract, with performance-related contractual payments for services rendered.

The managers and staff of some organisations have made this transition successfully. In others, the evolution is still at a very early stage. It is part of EBRD's role to help those who wish to follow this path.

7.3 *Conflicts of interest*

The task of a public authority is to ensure the delivery of services. Where the public authority provides the services itself and assumes the role of employer too, a conflict of interest arises. Achieving value for taxpayers' money through the application of competition may be in conflict with the interests of employees, at least in the short term.

7.4 *Scope for public transport network rationalisation*

Given the political focus on achieving visible progress quickly, there has been a tendency to focus on investment rather than the less visible and difficult area of operational efficiency.

Many cities in the region have too many transport technologies: tram, trolley, bus and sometimes microbus, suburban rail or metro. This is an inheritance from the application of soviet-style planning.

In a number of cases, demand has changed dramatically over the past decade and while some adjustments may have been made to service networks, usually no fundamental review has taken place. In some cases, it seems likely that substantial operating economies could be made if services were better matched to current demands, and the political environment enabled some fundamental organisational changes to take place.

7.5 *Sustainability*

Many references can be found in the literature suggesting that Central European cities are repeating the mistakes of western cities by accommodating ever-increasing motorisation. Indeed, there are relatively few good examples in Central Europe of a sustainable urban transport policy, with a balance between investment, traffic management, pricing, operational improvements etc.. There are, however, clear examples where large investments are being made in urban road infrastructure and yet investment funds are lacking for public transport.

8 THE NEXT GENERATION OF PROJECTS

8.1 *Attracting European Union grants*

The New Member States of Central Europe are set to receive some €22 billion from European Union Cohesion and Structure Funds over the period 2004-6.

Each country has negotiated and agreed priorities with the European Commission. Urban transport is expected to be a beneficiary in some countries, and cities and operators are, understandably, focusing on attracting such grant funds.

It is expected that the European Union may fund up to 75% of total project costs, meaning that the sponsor has to fund the balance itself or from borrowings. EIB will have a key role in co-financing Cohesion and Structure Fund projects generally. EBRD expects to co-finance a number of projects where clients appreciate the value that EBRD can add through project structuring, and supporting related reforms and institutional strengthening.

8.2 *Corporate financing for transport operators*

As indicated above, governments have borrowing constraints and may be keen to decentralise financing responsibilities to a lower level. In the case of urban transport, this usually means to a municipality and, if possible, an urban transport company.

For municipalities that are at or close to their statutory borrowing limits, the PSC-based structure outlined above has the advantage of enabling an authority to mobilise investment and speed modernisation using off-balance sheet financing. This can be a key element in a city's long-term financing strategy.

EBRD is working with a number of operators and cities on such a structure, including UAB Kauno Autobusai and the City of Kaunas. There are various legal and other challenges to resolve in the process. Nevertheless, once this model has been established, it will be available as a tool for other cities in the region.

Where the environment is developed and stable, the aim is to lend to the operating company with a "support agreement" from the client authority. Where risks are higher, a full or "liftable" municipal guarantee would be necessary.

8.3 *Parking concessions*

Many cities are experiencing acute parking problems associated with increasing motorisation. Parking is an activity that can generate revenues and, as indicated above, can therefore potentially attract finance.

Various proposals have been conceived in the region for off-street parking garages. However, gaining control over on-street parking is a precondition for financial success. Some cities in the region, such as Warsaw and Zagreb, have taken steps towards this end.

EBRD is working with the City of Sofia, for example, to elaborate a parking strategy. Based on an analysis of supply and demand, and financial viability, the Bank aims to assist the City to tender and contract for the development and management of on- and off-street parking in and around the city centre.

EBRD can in principle consider financing a parking concessionaire or contractor, subject to standard Bank criteria.

8.4 *Footnote on Public Private Partnerships*

Public Private Partnerships (PPPs) may be considered as a way to speed infrastructure modernisation when public finances are constrained. PPPs in the transport sector may be economically attractive when there is substantial new construction or where significant operating efficiencies can be achieved. However, this needs to be verified ion relation to a "public sector comparator" to ensure value for money.

Since PPPs are relatively complex to prepare and negotiate, transactions need to be relatively large to offset transaction costs.

Because of the relative sophistication of PPP structures in legal and financial terms, clients need suitably qualified and experienced staff. This is difficult to achieve at local level and so attempts have been made in some countries to provide national-level support. EBRD is engaged in technical co-operation with the Ministry of Infrastructure in Poland to establish a PPP Task Force. EBRD can also draw on its experience with water sector concessions/PPPs in Bulgaria and Romania.

9 EUROPEAN BANK FOR RECONSTRUCTION AND DEVELOPMENT

9.1 The Bank

The European Bank for Reconstruction and Development (EBRD) was set up in 1991 to aid the transition from centrally planned to market economies in central and eastern Europe and the Commonwealth of Independent States. The EBRD is owned by 62 shareholders - 60 countries, the European Investment Bank and the European Community - and operates with €20 billion in capital.

The EBRD finances projects in both the private and public sectors. A strength of the EBRD is its in-depth knowledge of the region as well as specific sector expertise. The Bank is based in London and has regional offices in all countries of operation.

The EBRD operates in 27 countries from central Europe to central Asia:

Albania, Armenia, Azerbaijan, Belarus, Bosnia and Herzegovina, Bulgaria, Croatia, Czech Republic, Estonia, FYR of Macedonia, Georgia, Hungary, Kazakhstan, Kyrgyzstan, Latvia, Lithuania, Moldova, Poland, Romania, Russia, Serbia and Montenegro, Slovak Republic, Slovenia, Tajikistan, Turkmenistan, Ukraine, Uzbekistan.

9.2 Transition

EBRD is sometimes referred to as the "transition bank". What does this mean? EBRD has a mandate to support the following:

- Competition: greater competition in the project sector
- Market expansion: Expansion of competitive/market interactions;
- Private ownership: More widespread private ownership and entrepreneurship;
- Frameworks for markets: Institutions, laws and policies that promote market functioning and efficiency;
- Skills: Transfer and dispersion of skills;
- Demonstration effects: Transfer of new behaviours and activities;
- Standards: Setting standards for corporate governance and business conduct.

If a client subscribes to some or all of the above aims, there are many ways that EBRD can assist in achieving transition in the urban transport sector.

9.3 Technical co-operation

The Bank is fortunate in having a number of technical cooperation trust funds that may in principle be tapped to fund expertise on a grant basis to assist clients to prepare investment projects, or carry through agreed reforms.

The availability of such funds has decreased in recent years and therefore the Bank now focuses technical cooperation on transactions that are viable and support transition.

10 REFERENCES

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