Analysis of Finance Options and Models, and Financial Support Measures for Public-Private Partnerships in Serbia[1]

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Considering that the Public-Private Partnership and Concessions Law (PPPCL) was enacted a year ago, one of the main issues is what else, apart from the legal frame, needs to be perfected in order to put public-private partnerships into practice. A clear, comprehensive and flexible regulatory frame is necessary but in itself not sufficient for the successful implementation of PPPs.[1] In this paper, we primarily analyze funding possibilities and modalities, and practicable support measures for PPP projects in the Republic of Serbia, focusing on the local government tier and public utility companies.

As PPP development is closely linked to project finance, a short overview of project finance is given in the second chapter. In the third chapter, we analyze how project finance is regulated in Serbia, in the context of PPPs, and the funding modalities, devoting a great deal of attention to stakeholder relations with respect to security and the possibility of stipulating a direct agreement. Also in the third chapter, we assess the new regulatory framework for funding PPPs. In the fourth chapter we analyze funding mechanisms, the impact of the public utility companies (PUC) debt ceiling, and of the existing public procurement regime, on the development of PPPs. In the fifth chapter we examine the possibility for the introduction financial support measures for PPP projects, and risk management measures. In the sixth chapter we conclude.

1. Project finance

Project finance can be defined as a method of funding projects where "lenders and investors rely either exclusively or mainly on the cash flow generated by the project to service their loans"[2], or as "financing the development or exploitation of a right, natural resource or other asset where the bulk of the financing is not to be provided by any form of share capital and is to be repaid principally out of revenues produced by the project in question"[3], or where "banks provide finance for a single project and take a large part of the risk for the success or failure of that project".[4] Essentially, project finance relies on the transfer of the financial risk of a certain project to the financier himself. Formal project finance entails[5]:

(i) a credit/loan contract, i.e. a credit relationship as the main form of financing, with adequate collateral;

(ii) a project company, as a rule founded for the sole purpose of implementing a certain project;

(iii) financing with project company capital, as an additional form of financing, (and regardless of whether the capital is provided by lenders or the founder of that company – the so called sponsor); and

(iv) a series of accompanying commercial contracts, from construction contracts to supporting financial agreements related to project insurance policies, to bank guarantees, to hedging, etc.

In addition to the listed elements, project finance can also entail the granting of concessions to the project company, which becomes a special purpose enterprise (according to the PPPCL terminology).[6]

1 For an analysis of the PPPCL please refer to Radulović B. And D. Nenezić "Novi regulatorni okvir za javno-privatno partnerstvo u Republici Srbiji – učenje na sopstvenim ili tuđim greškama" in *Usklađivanje poslovnog prava Srbije sa pravom Evropske Unije*, Vuk Radović (edit.), Law Faculty of the University of Belgrade, Belgrade, 2012, pp.190-219.

2 Please refer to the European PPP Expertise Centre, *PPP Guide*, dostupan na http://www.eib.org/epec/g2g/annex/1-project-finance/index.htm (12.11.2012).

3 Vinter, G. and G. Price, *Project Finance: A Legal Guide*, Sweet & Maxwell, London, 2006, pp.1. For more detailed information on project finance, also please refer to Yescombe, E.R., *Principles of Project Finance*, Academic Press, London, Boston, 2002.

4 Wood, P.R, *Project Finance, Securitisations, Subordinated Debt*" Sweet & Maxwell, London, 2007.

5 For a detailed classification, please refer to Wood, op.cit.

6 As the Law envisages the establishment of a special purpose enterprise for every PPP project, regardless of whether it is a PPP with or without the elements of a concession, this issue deserve particular attention. For more information about the manner envisaged in PPPCL for establishing a special purpose enterprise for every PPP project, please refer to Radulović, B. and D. Nenezić, (2012), pp.206-07.

Certain common rules have been established in comparative practices that depart from the "general" PPP project finance regime.[7] These are departures with respect to the forms of financing, risk allocation, and funding sources. As regards the forms of financing, the project company's share capital and the senior debt [8] are typically the main sources of funding of PPP projects, and the secondary source of funding is junior debt[9], as a rule provided by sponsors. [10] In terms of risk allocation, this entails a two-pronged approach. On the one side, the risk is divided between the public and private sector, which is the *differentia specifica* of the PPP concept. On the other side, the risk is shared between the private sector stakeholders, i.e. between the sponsor and lender. This type of risk transfer within the private sector is the most significant departure from the aforesaid "general" regime, considering that the risk transferred to the lender is limited through the allocation of the risk to the rest of the private sector stakeholders, such as sponsors, contractors, guarantor banks or insurance companies, etc. Finally, in PPP project finance, the financing sources themselves are divided into public and private sector.[11] The allocation of the financial burden between the public and private sector will differ depending on the bankability of a PPP project for the financiers, of the risk related to its implementation, and the cash flow it generates, as these factors will also affect the project's gearing level. In any case, project finance in the context of PPPs is a relatively complex set of relations that depend on a number of related factors.

A successful PPP project, as well as its successful financing, entails clearly regulated relations, which means an adequate regulatory frame that will standardize these relations. Naturally, the implementation of PPP projects in the Republic of Serbia also requires adequate sources of funding, and attractive PPPs for the engagement of these funds in a manner regulated by the legislative frame. As the assessment of the PPP projects that can be implemented in Serbia currently is outside the scope of this paper, in this chapter we will focus on:

– the assessment of the regulatory framework for funding PPPs, primarily the provisions of the PPPCL (concerning the financing models, risk allocation and financing instruments), from the perspective of comparative PPP laws, international standards[12] and national law on/applicable to (*inter alia*) project finance;

– currently available funding sources for PPP projects on the Serbian market (to the extent that this is public information).

2. Regulatory frame for funding PPPs in the Republic of Serbia: finance models and stakeholder relations

Even at first glance, it is evident that the drafting of the PPPCL was influenced by (prospective) lenders, and consequently the adopted solutions allow for a very flexible approach to (project) finance.[13] By content, the provisions on finance can be divided into provisions on finance models and provisions on the relations between the stakeholders, i.e. the private partner, the public partner and the financier, including the issuance of guarantees, the possibility of stipulating a so called direct agreement, and lien, in the section regulating the rights and obligations in the procedure of the implementation of a PPP contract (public contract).

7 The overview of these rules is in line with the *EPEC PPP Guide*.

8 Senior debt is a debt that takes priority for repayment in case of the borrower's insolvency, after the settlement of debts with statutory priority. In the Serbian Insolvency Law, senior debt consists of the claims of secured creditors, excluding creditors, and third-ranking creditors who did not agree to have their claim settled after the full settlement of other creditors. Please refer to Art. 54 of the Insolvency Law.

9 Junior debt is a debt that has lower priority for repayment than the senior debt in a liquidation, but takes higher priority than the repayment of the debt claim of the owners of the bankruptcy debtor. Apart from the creditors who agreed to the repayment of their debt claim after all other (bankruptcy) creditors are paid in full, i.e. third-ranking creditors, according to the Serbian insolvency law, the debt claim also consists of debt claims for loans granted to the company by its shareholders, except when the latter are engaged in issuing credits or loans within the scope of their regular line of business. In addition to Article 54 of the Insolvency Law, please also refer to Article 181 of the Company Law regulating the provision of loans and security by company shareholders. The case law has yet to take a stand on this article, in the context of the Insolvency Law.

10 In addition to the share capital, which bears the greatest risk of the project, typical sources of funding include loans issued by commercial banks and international financial institutions, and local government budget funds. Local government funds as a source of funding are used either to increase the financial profitability of the PPP project or to increase the local government's share in the project's future revenues. Moreover, raising capital by issuing bonds is an alternative financing model.

11 In fact, in project finance terminology, the ratio between the funding provided by the lender and the funding provided by the sponsor is called a project's gearing. The higher a project's gearing, the lower the financial burden of that project on the public sector. And vice versa, the lower the project's gearing, the higher the financial burden on the public sector.

12 For instance, one of the internationally recognized standards is the Loan Market Association (LMA) model, used by most international lenders present on the Serbian market, who are at the same time members of that association. For more information please refer to http://www.lma.eu.com/landing_aboutus.aspx (10/11/2012).

13 The main provisions on finance are contained in Article 49 (*Public Contracts Finance*) in the section regulating public contracts, while secondary provisions can be found in Articles 71 and 72, in the section regulating the rights and obligations in the of implementation of public contracts (*Lien* and *foreign currency regime for PPP with or without elements of a concession*).

2.1 Finance models

Legal provisions concerning finance models are based to the greatest extent on the PPP finance rules examined in the previous section. According to the PPPCL, a PPP agreement can be financed by the private partner through a combination of direct investments in capital or with borrowed capital. The types of borrowing envisaged are project and structured finance, *exempli causa*.[14] International financial institutions, banks, and also third parties may be lenders, hence, given the generality of the term "third party", practically any legal entity or individual.

Aside from the fact that both finance models are possible – i.e. credits/loans (or other "financial products" in the case of structured finance), and capital, the PPPCL recognizes two forms of borrowing that were previously not present to any significant extent in Serbian legislation. Unlike the term "project finance", which was present in certain by-laws regulating banking operations (as was "junior debt"), as far as we know, the term "structured finance" was introduced in Serbian legislation for the first time with in the PPPCL. The only type of finance not covered by Article 49 of the PPPCL, is junior debt. Nevertheless, its use is not forbidden, considering that the forms of funding in this provision are not limited to the ones listed therein. Furthermore, the law also mentions the refinancing of PPPs in connection with claims that can be secured, which is very important in the context of possible problems with debt recovery.

2.2 Stakeholder relations – security instruments and restrictions

The new regulatory frame regulates relations between the private partner and lender[15] in accordance with standard rules on funding PPP projects. The private partner is authorized to provide certain security instruments in favour of the lender. These security instruments are defined very broadly, and include anything from mortgage, and lien on movable assets and rights, to the "allocation" of rights and obligations under a public contract or of other project related assets, (which opens the possibility for stipulating contracts with different content types, based on the general provisions of the law on contracts and torts, i.e. with elements of debt assignment, cession, takeover, etc.). In addition to defining security, the law establishes that a security may be created over the assets that are the subject-matter of the agreement, and/or over a share in the joint business company (i.e. the special purpose enterprise). It is particularly important to note that security can be created only with the prior consent of the public partner, pursuant to the law regulating public ownership, which is an issue that we will discuss in further detail.

At the request of the lender and private partner, security can be provided by the public partner as well, provided that their request is a "reasonable request". This formulation seems to leave the interpretation of the request entirely to the will of the public partner, and consequently, the latter's readiness to cooperate will determine the extent to which he will be an impediment to the successful implementation of PPP projects in practice. The dependency on the public partner's will gains even greater prominence if we consider that the rights pertaining to security cannot be transferred or assigned to third parties without the express consent of the public partner.[16] Hence, the consent of the public partner is required for:

– the perfection of security by the private partner;

– the "reasonable request" of the lender and the private partner with respect to the granting of a security by the public partner itself;

– the transfer or assignment of the rights pertaining to the perfected security instruments to third parties.

However, in addition to the restrictions resulting from will of the public partner, (Article 71 of the PPPCL), the rights of the private partner are also restricted by the Law on Public Ownership. In fact, the law envisages that a security interest or other security can be perfected in favour of a bank or other financial institution,[17] except in the case of assets that cannot be mortgaged or offered as security under the law regulating public property. The implications

14 As there are numerous definitions of structural finance in scientific literature, the safest option seems using the normative term, i.e. the definition provided in the EU legislation, specifically *Regulation (EC) No. 1060/2009 of the European Parliament and of the Council of 16 September 2009 on credit rating agencies*, and *Directive 2006/48/EC of the European Parliament and of the Council of 14 June 2006 relating to the taking up and pursuit of the business of credit institutions*. According to these acts, a structured finance instrument is a financial instrument or other assets resulting from a securitisation transaction, while securitisation itself is defined as a transaction or scheme, whereby the credit risk associated with an exposure or pool of exposures is tranched, having the following characteristics a) payments in the transaction or scheme are dependent upon the performance of the exposure or pool of exposures; and b) the subordination of tranches determines the distribution of losses during the ongoing life of the transaction or scheme. In a less technical definition, Wood defines securitisation as a sophisticated form of factoring or discounting of debts – please refer to Wood, op.cit, 6–001 and further.

15 The provision of the law clearly indicates that these are two different entities.

16 Please see Art. 71 PPPCL

17 The established term "lenders" was probably not used due to an editorial omission.

of this provision will be examined in more detail in the next chapter of this paper. At this point, we would only like to note the significant discrepancy between the provisions concerning the possibility to stipulate a direct agreement, and the provisions concerning security instruments, with respect to the span of the lender's rights.

2.3 Stakeholder relations – direct agreement

A direct agreement is a universally recognized institute in comparative law[18]. The objective of a direct agreement is to enable the lender to step into the contractual role (i.e. "step into the shoes") of the private partner if it finds itself in financial difficulties, and thus keep the PPP project going[19]. The PPPCL envisages the following possibilities, (along with the general residual provision on "all other standard provisions" in the interest of the public partner and lender), when a direct agreement is concerned[20]:

– the lender may temporarily exercise rights under a public agreement, in other words rectify any omissions by the private partner, and the public partner is required to accept these actions as if they had been carried out by the private partner itself;

– the private partner is required to request the prior consent of the lender for the cancellation, i.e. termination of the public agreement at the request of the public partner;

– the public partner must request that the lender rectify any oversights of the private partner before filing the appropriate request;[21]

– the prior consent of the public partner is required for the temporary or final assignment of the contractual position or any other right of the private partner, and/or for the perfection of the security interest provided by the private partner.

The law sets forth that the stipulation of a direct agreement is subject to the prior consent of the authorities (i.e. the Government of Serbia, the government of the autonomous province or the local government assembly), depending on the tier of the public partner. Once the consent is granted, the lender may exercise its rights without the need to seek any further, subsequent approval. It seems that the aforesaid provisions on the prior consent of the public partner, and on the finality of the prior consent of the authorities when the direct agreement is concerned, aimed to compensate for the negative effects that may arise in connection with the numerous consents required for the perfection of security interest. Thus, the direct agreement is attributed special importance, as it is emphasized as a more favourable form of protection of the interest of the lender than the simple perfection of some collateral.

As can be seen, the content of the direct agreement, the clauses on the prior consent of the authorities, and the senior level of protection of the lender's interests, emphasize balanced rights and obligations of the public partner and lender, which is essentially a requirement for the success of any PPP project. On the other hand, direct agreements foresee only obligations for the public partner. Such a body of *step-in* rights upholds the thesis that the drafting of this section of the PPPCL was significantly influenced by international lenders with extensive experience in PPPs, probably as a result of expectations that direct agreements would be frequently applied in practice. This expectation is all the more plausible if we compare the clauses of the direct agreement with the clauses on security instruments and security interests, which leads us to the assumption that lenders with sufficient knowledge and experience will always opt for a direct agreement. However, the implementation of PPP projects will certainly be called into question if the public partner is less cooperative, because that would hamper the stipulation and/or adequate enforcement of a direct agreement. Hence, it can be anticipated with absolute certainty that the use of direct agreements will be restricted to PPP projects financed by international financial institutions, given the proverbial acceptance of their conditions by (potential) public partners.

18 Please refer to Vinter, Price, op.cit. p. 273, and further. A direct agreement is merely the basis for the enforcement of the so called *step-in* right, i.e. the right of the lender to step in to the project company's position. For more information on these two terms in the comparative context, please refer to the *Legal Framework Assessment* of *PPP in Infrastructure Resource Center for Contracts, Laws and Regulations,* kept by the World bank, available at: http://ppp.worldbank.org/public-private-partnership/legislation-regulation/framework-assessment/legal-environment/lender-issues-step-in-rights.

19 The *Green Paper* states that the step-in clause is activated if the financial flows generated by the project fall below a certain level – please see item 48. In the same item, it is stated that the implementation of the step-in clause may result in changing the private partner without a call for competition. This may lead to certain problems in Serbian practice that will be addressed further on in our paper.

20 This is a classic repertoire of the so called *step-in* rights. For more detailed information please see Vinter, Price, ibid, where these step-in rights almost entirely correspond to the rights listed under paragraph 3, Article 49 of the PPPCL. In addition to that, the structure of Article 49 to a great extent follows the structure of the corresponding sections of the *Legal Framework Assessment* of the World Bank Resource Center, which will certainly be useful for interpreting and resolving any concerns that might arise in the enforcement of the PPPCL.

21 It seems that the term "request" actually refers to a claim, i.e. that it is an inaccurate translation of the English term "claim".

2.4 Assessment of the PPPCL clauses on funding PPPs

With a view to this short analysis of issues related to security, restrictions and the direct agreement, the ensuing conclusion is that the PPPCL has fulfilled some of the key conditions required for a proper legal frame according to comparative practice with respect to enabling PPP financing. The fact that the clauses do not go ahead of the existing legislative frame in Serbia is also laudable. The PPPCL makes no mention of novel financial products that have no place in the Serbian market currently, as is the case with some other regulations. Instead, it remains within limits that are broad enough to encompass both currently available products (first of all classic project finance), and those that can be expected to emerge in the future (e.g. certain structured finance instruments). In this regard, we hope that the application of PPPCL provisions will allow for the use of a contractual model typically used in international finance transactions, such as the LMA, mentioned previously. The frame set by the law certainly facilitates the use of these models, in the interest of all stakeholders as well as market development in Serbia.

3. PPP finance mechanisms

Talking about existing PPP finance mechanisms is not easy, given that PPPs did not exist in Serbia prior to the enactment of the PPPCL, *stricto sensu*, but only tentatively, in the context of utility outsourcing and a few concessions. However, one can certainly examine the PPP project finance frame that existed outside the PPPCL, which, along with the aforementioned restrictions of the regulatory frame, will determine whether or not PPPs will finally come to life in the Republic of Serbia. This frame is mainly restricted to regulations on public debt, and to some extent also to the regulations on public utility companies (**PUC**), public property, insolvency and public procurement.

3.1 The impact of the debt limit of public utility companies on the development of PPPs

In terms of debt, the local government in Serbia can be conditionally divided into two groups.[22] The first group consists of towns and large municipalities that have more or less reached the debt ceiling set by the Public Debt Law.[23] The second group consists of smaller municipalities that are far from reaching that limit, but lack satisfactory creditworthiness,[24] consequently these are of no interest to banks. Poor creditworthiness of the smaller municipalities naturally does not rule out the possibility of funding by international financial institutions or foreign development banks, where such loans are as a rule accompanied by state guarantees, which will be discussed in more detail further on.

Bearing in mind this dichotomy of the local government, PPPs are generally a particularly suitable solution for local governments that have reached the debt ceiling, and are in need of significant capital investments. For a local government, reaching the debt ceiling means that it cannot finance capital investments from loans, and that capital investments can only be financed by the PUCs of these local governments, either from their own revenues, which is not very likely considering their inefficiency,[25] or from capital borrowed by these PUCs independently, which is also not a very likely scenario considering a number of limiting factors. The key limiting factors of the PUC's debt capacity are the following:

– *Inefficiency of PUCs and cash flows that only allow for short-term loans, typically due to low tariffs, limited budget support and a set of other problems*;

– *The inability to create security over PUC assets, due to restriction imposed by the Public Debt Law* – when the ownership of the assets is not vested in the PUC, i.e. the PUC has use rights over assets that are in public ownership;

– *The inability of the local government to issue guarantees pursuant to the Public Debt Law,* which can be compensated to a certain extent by *sui generis* indirect guarantees in the form of "support agreements", encouraged by the Draft Strategy for Restructuring the PUC[26];

22 The division was made based on an analysis of the leverage level of towns and municipalities according to data from Q3 of 2012. A detailed analysis that would specify the exact leverage level not only of local government but also of the public utility companies would probably allow for a more accurate classification.
23 Art. 36 of the Law on Public Debt.
24 "Support Agreement" is the term used in the last version of the *Draft Strategy for Restructuring the PUC*. The previous version of the Draft Strategy, available at http://www.misp-serbia.rs/wp-content/uploads/2010/05/Strategy-for-Restructuring-the-PUC-Draft.pdf, uses the term "support agreements", please . p. 43.
25 For more information on PUC results of operations, and inability to finance capital investments, please refer to Radulović, B. and D. Nenezić (2012). Based on the analysis of PUC financial statements for 2010, the authors established that as many as 136 PUCs registered net losses in the total amount of RSD 6.5 billion. Also, for more information about the efficiency of operations of PUCs, please refer to M. Arsić, "Reforms of state owned and public enterprises", *Quarterly Monitor No*. 28, and *Proposal for fiscal consolidation measures 2012-2016*, drafted to a great extent based on M. Arsić's paper.
26 *The Draft Strategy* states that these agreements guarantee payments in case the tariffs charged by PUCs have not been sufficiently incremented to ensure the repayment of the PUC debt, thus assuring creditors that there is adequate financial support, and mitigating the political risk. This mechanism is essentially a violation of the Public Debt Law with respect to the inability of the local government to provide guarantees, which the authors indirectly admit in the *Draft Strategy* stating that the agreements "...will not be a direct guarantee for PUC debts", p.45.

Article 14 of the Insolvency Law, which envisages that legal entities founded by the Republic of Serbia, the autonomous province or local government unit, and exclusively or predominantly financed from public revenues or the budget of the Republic, the autonomous province or local government, are not subject to bankruptcy proceedings, and the founders, i.e. owners are jointly and severally liable for the obligations thereof, which puts us back in the domain of the restrictions imposed by the Public Property Law.

If loans or PUC revenues are not realistic options, then PPPs are not only the adequate solution, but in fact the only possible solution, (considering that the PPPCL now allows the implementation of PPPs both at local government level and at PUC level). In that sense, a PPP can be positioned as a form of capital investments finance between local government borrowing, PUC borrowing, and PUC own funds.

For ease of reference, this range of options is also presented in the form of a table, along with the requirements and restriction applying to each of them:

	Requirements	Restrictions
The capacity of local government to take a loan independently to finance capital investments	The capacity to restrict the debt to the limit set by the Public Debt Law	Exceeding the debt limit set by the Public Debt Law (over-indebtedness)
	Stable cash flows	Poor cash flows that only allow for short-term finance
	Adequate security – state guarantee, as a rule	Risks related to state guarantees
Financing capital investments through PPPs	Ownership requirements for the implementation of PPP – assets owned by PUCs	Inability to create security over assets that are in public ownership used by PUCs
	The possibility of stipulating "support agreements" with local government instead of guarantees (indirect guarantees)	Inability of local government to issue guarantees
	Institutional requirements for the implementation of PPP projects – adequate administrative capacities of local government	Poor local government administrative capacities
The ability of the PUC to take loans to finance capital investments	Efficiency of the PUC and stable cash flows	Inefficient PUC and poor cash flows
	Capacity to stipulate a support agreement with the local government instead of guarantees (indirect guarantee)	Inability of local government to issue guarantees
	Adequate collateral – assets owned by PUC as opposed to use of public property	Inability to create security over assets in public ownership used by PUCs
		Special regime of joint and several liability of the founders and shareholders as opposed to instituting bankruptcy proceedings against the PUC
The capacity of the PUC to fund capital investments independently	Efficient PUC and stable cash flows	Inefficient PUC and poor cash flows

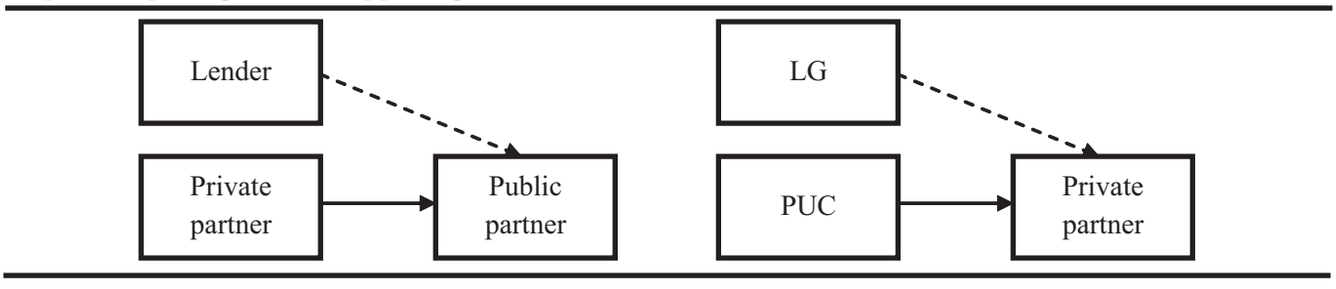
In addition to ownership requirements (assets owned by PUCs), and institutional requirements for the implementation of PPP projects (local government administrative capacities), the use of PPPs will rely to a great extent on the possibility of stipulating "support agreements" with the local government, to compensate for the lack of guarantees. As with financing capital investments through PPP, relevant factors can be examined, and capital investments finance models can be identified relatively easily.

3.2 "Support agreements" and the public procurement system

In addition to the restrictions outlined above, the development of PPPs in the scenario described in the above table is related to another important problem, namely the existing public procurement system. The focus here is not on the general weaknesses of this system, but rather on the restrictions resulting from the implementation of PPP projects where a PUC appears as the public partner, with some support from the local government (e.g. the stipulation of a "support agreement").

In fact, as the party entering into a "support agreement" with the public partner, i.e. with the PUC, the local government has a role similar to that of a lender assuming the contractual position of the private partner towards the public partner. In the event of the public partner encountering financial difficulties (e.g. in the event that the tariffs are not sufficient to service the PUC's debt), the local government takes over the role of the public partner (just as the lender would in respect of the private partner), which, to an extent, reflects the arrangement of joint and several liability of the founder of the public utility company, where the former services the latter's liabilities to the private partner (just as the lender would to the public partner).[27]

Graph 1. Step-in rights and "support agreements"



The similarity between these two relationships may be clarified by graphic presentation. The dashed line represents the primary relationship between the public partner (i.e. the PUC) and the private partner, while the solid line represents the secondary relationship, which is activated when one of the partners is no longer able to settle its liabilities towards the other partner, i.e. when a third party assumes the first partner's liabilities towards the other partner, either by assuming its contractual position on the grounds of *step-in* rights (left-hand graph), or by fulfilling its obligations under a "support agreement" (right-hand graph).

However, should local governments find themselves in this position, a conflict would arise between their role as a contracting authority under the Public Procurement Law on the one hand and their role as a party obliged to intervene under a "support agreement", which may include specific obligations to procure goods or services, which would normally be subject to the public procurement legislation (and which would be carried out by the PUC itself under analogous application of the Public Procurement Law, as foreseen by the PPPCL for PPPs without concession elements). For instance, within a PPP project, a PUC may undertake to purchase all recyclable waste collected in the territory of a local government from a private partner; if the PUC is not able to service its liabilities to the private partner, these liabilities will be settled by the local government that has "supported" the PPP project, whereby it will directly contravene the public procurement legislation as the required procedure for public procurement of goods will not be launched.[28]

A solution to this problem may appear in the EU law, in particular the European Court of Justice case law and the planned amendments to the public procurement legislation.[29] In view of the strict sanctions foreseen in the Public Procurement Law for violations of its provisions, in particular voidness of contracts concluded in breach of the obligation to apply the Law, we are of the opinion that this situation should be codified as part of the announced public procurement system reform in Serbia; otherwise, the scope for PPP would be further narrowed or would be liable to substantial legal insecurity in respect of private partners. Finally, the question of the possibility of applying a "support agreement" as a way of providing the prerequisites for financing capital investments through PPP arises in

27 This, to an extent, reflects the arrangement of joint and several liability of the founder of a PUC in conformity with Art. 14 of the Insolvency Law.

28 This conflict is particularly pronounced if we recall the exclusion of competition that the *Green Paper* links with the exercise of the step-in right, which would imply that this form of procurement should not be subject to the Public Procurement Law, although this is not stipulated among the allowed exceptions in Art. 7 of that Law.

29 For an introduction to the subject concerned, see *Commission Staff Working Paper concerning the application of EU public procurement law to relations between contracting authorities ('public-public cooperation'*, available at: http://ec.europa.eu/internal_market/publicprocurement/docs/public_public_cooperation/sec2011_1169_en.pdf, for a sketch of a possible solution and the criteria it should meet.

the context of the Public Debt Law. This question will be discussed in more detail in the next chapter.

4. Can other arrangements be applied in Serbia to enhance PPP implementation?

In addition to the restrictions outlined above, PPP implementation and finance possibilities in the Republic of Serbia face further challenges. The first challenge concerns the global financial crisis, which aggravates the problems related to financing PPP projects. On the one hand, investors are very cautious in such circumstances, and the risks of doing business in Serbia, institutional and regulatory restrictions and lack of experience in PPP implementation, as well as insufficient quality of proposed projects deter investors. On the other hand, it appears that, despite this, there are enough investors (primarily international financing institutions – IFIs) interested in various forms of PPP, but potential investors expect higher involvement of the state or local government, as appropriate, both in terms of finance and in terms of guarantees and risk allocation.[30]

It is almost certain that, in the Serbian case, multilateral and bilateral financing organisations will have the role of catalyst of PPP project finance. By financing PPP projects from the sources of the European Investment Bank, European Bank for Reconstruction and Development, International Finance Corporation or bilateral financing organisations, the public sector obtains relatively favourable funding sources, which is of particular importance in major infrastructure projects. Lower project cost in case these funding sources are available is certainly a good reason to consider PPP modalities as relevant options. Other investors beside IFIs, in particular commercial banks, are also likely to start seriously considering the possibility of channelling more of their investments into high-quality PPP projects. The reason for the anticipated interest on the part of commercial banks lies primarily in the fact that the risk of providing credit for PPP projects is normally lower compared to projects involving private sector only. Another reason is the already appreciably high level of non-performing loans granted to the private sector.[31]

In addition to affecting the willingness to invest in PPP projects, these circumstances also decelerate project negotiations. For example, if an international financing institution is involved in a segment of a PPP project, the procedure usually lasts longer. In such circumstances, specific environmental, social or public procurement requirements are imposed. Also, launching a PPP project during a crisis is certainly more complex and more time is required to conclude an agreement. Owing to the fact that only one PPP procedure has been finalised since the entry of the new law into force, it is too early to estimate the expected average length of the procedure in Serbia, but it can realistically be expected that it will be longer in the initial years of implementation of the law.[32] The length of the procedure can also discourage potential private partners and lenders from entering the Serbian market.

The results achieved to date in implementing public-private partnerships (only one agreement realised in Serbia since the entry of the new law into force) are certainly far below the expectations of those who are of the view that comprehensive implementation of PPPs is possible and desirable in Serbia. Therefore, the question is whether it is possible or necessary to use other support mechanisms in order to facilitate wider application of PPP modalities in financing infrastructure projects. Naturally, consideration of different forms of support is justified only if the prerequisites of PPP (primarily the economic feasibility of the project) are met.

By areas, the state can exert influence by means of measures affecting the modality and conditions of financing PPP projects, risk management modality, public procurement procedure and the selection of the PPP modality itself. Since the topic of the paper is finance models, possibilities and restrictions, we shall consider in particular the arrangements affecting the modality and conditions of financing PPP projects and briefly review arrangements concerning the risk management modality.

30 In practice, financing was usually indirect (through the state), i.e. with state guarantee, while typically co-financing was also required.

31 According to the National Bank of Serbia's most recent available quarterly report on the banking sector in Serbia, the level of non-performing loans has reached 19.5% of all granted loans (in gross terms). More information available at http://www.nbs.rs/export/sites/default/internet/latinica/55/55_4/kvartalni_izvestaj_II_12.pdf. Comparative data give rise to the conclusion that the economic crisis has not significantly affected the number of refinanced loans in the PPP sector globally. For more information, see the report of the auditing and consulting company PriceWaterhouseCoopers *PPPs in the aftermath of the financial crisis – a global overview* dated 24 March 2011, available at http://www.oecd.org/gov/budgetingandpublicexpenditures/47814518.pdf.

32 Considering that the PPPCL is largely modeled after the old Croatian law, in the event that problems arise with regard to the speed of procedures, amendments can be expected in order to accelerate the procedure, in view of the fact that one of the main changes in the new Public-Private Partnership Law of the Republic of Croatia concerns the speed of resolving specific matters in the process of preparing and approving project proposals.

4.1 Financial support measures for PPP projects

Most measures pertain to different forms of providing financial support for PPP projects. International experiences clearly indicate that few PPP projects can be sustainable without significant financial and technical support from the state. In case of financial support, as a rule, the prevailing option is the provision of guarantees (by the state or local governments) to facilitate financing projects under more favourable terms.[33] While borrowing restrictions for public utility enterprises are certainly conducive to PPPs, limited possibility for local governments to provide guarantees represents a significant obstacle to PPP development. According to the Draft Strategy for Restructuring PUCs, local governments should be allowed to give guarantees for the debts of their PUCs, provided that such debt is not included in the statutory limit under the Public Debt Law and that the debt is repaid by the PUC itself, under the assumption that there is oversight of such guarantees.[34] Yet, great caution is needed in this matter.[35] The Fiscal Council has clearly pointed to a problem concerning the rapid growth of state guarantees issued for public enterprises' debts in the past three years. In the event that a large number of local-level PPP projects is treated in the same way, the outcome could be highly unfavourable and fiscally unsustainable. A detailed discussion of whether municipalities should issue guarantees certainly exceeds the scope of this paper.

Provided that the problem concerning public procurement is solved, the abovementioned "support agreements" as an alternative to guarantees have their advantages, but they are at the same time contrary to the Public Debt Law and their implementation would require amending this Law to expressly introduce these agreements as a possible model of financing capital investments at the local level. This certainly hinders the possibility of implementing this innovative solution, at least in the short term. In addition to direct and indirect guarantees, the private partner can also be compensated by a range of other specific arrangements – providing capital subsidies during the construction or paying an availability charge or subsidising service users. Naturally, instead of providing indirect guarantees in the event that tariffs are not sufficient to pay the PUC's debt, there is always the possibility of increasing them. All of these forms of support for financing PPPs are possible, but their effectiveness and efficiency must be considered on a case-by-case basis.

Another way in which the state can affect the modality of financing a project is simply *a higher share of the public partner in the capital*. A negative aspect of this option is that it weakens the incentives for the private partner owing to changes with respect to the transfer of risk. Also, it is probable that the possibility of a higher influence of the state on the operations would lead to compromising the efficiency of operations, and the special purpose enterprise would become prone to political influences. To an extent, influence on the project finance model can also be exerted by *more favourable tax treatment*, i.e. by reducing the tax burden in case of investments in PPP projects. Yet, this option requires complicated amendments to tax legislation and additional administration, and may create distortions and give wrong incentives. In any case, implementation of tax incentives requires more careful calculation of value for money.

In addition to many measures (guarantees, subsidies, tax incentives) that may be considered in the context of financial support for PPP projects, the local finance market should be given an opportunity to develop finance products that would enable financing PPP projects.

4.2 Risk management measures

Another set of measures that can affect interest in PPP projects, concerns risk management. According to the PPPCL, generally the risk has to be allocated to the side best equipped to handle it, (i.e. to mitigate it). However, the law also envisages the possibility of a "balanced" allocation of risk. This seems to open the possibility for creative interpretation of risk allocation, i.e. transfer. For instance, the question arises if there is any likelihood that private partners will seek state guarantees even in the case of the operator's inefficient performance. This is why it is very important to define the criteria for the allocation of risk precisely, i.e. to identify the types of risks that each of the partners should bear. In that respect, the Commission should play a significant role in terms of providing advice and methodological materials. [36]

Notwithstanding the necessary clarifications on the application of the PPPCL provisions regulating risk, better

33 Such view is also expressed in the Draft Strategy, according to which *"[t]he state should take part in order to improve availability of loans for financing of municipal infrastructure by providing guarantees for loans from international financial institutions and commercial banks"*.

34 The formulation of this recommendation is ambiguous and its meaning is not quite clear.

35 For details on risks posed by state guarantees, see *Proposed Fis*cal Consolidation Measures 2012–2016 , prepared by the Fiscal Council, available at: http://fiskalnisavet.rs/images/fiskalna_konsolidacija.pdf (23 November 2012).

36 Unfortunately, a year after the enactment of the PPPCL, the Commission still does not have a website.

finance conditions are possible if quality information is provided on potential risks, on potential private partners and lenders, in order to determine the appropriate risk transfer level. Additionally, here too, the partners have at their disposal different mechanisms for the mitigation of the risk, i.e. for insurance against the risk – provisions on refinancing, currency risk, sinking funds in case of need for major capital expenditures several years into project implementation, etc.

5. Conclusion

Although many circumstances make a case in favour of using PPPs to finance investment projects at local and regional level in Serbia, there are numerous restrictions too. In this paper we pointed out some shortcomings of the project finance regulatory framework. Nevertheless, the overall assessment is that the new regulatory framework is satisfactory to a significant extent. The PPPCL contains all the provisions (e.g. collateral, direct agreement, step-in rights, etc.) recommended in the relevant international models such as *EPEC's PPP Guide* or the *Legal Framework Assessment* of *PPP* of the World Bank Resource Center.

Despite the modern regulatory framework, as well as the fact that PPPs are generally a particularly favourable option for local governments that have reached the debt limit and have significant capital investment needs, so far there has been no progress in the application of PPPs. In addition to the ownership and institutional requirements for the implementation of PPPs, one of the obstacles is that local governments cannot issue guarantees, according to the Public Debt Law. In this context, the implementation of PPPs will rely to a great extent on the possibility of stipulating "support agreements", which would partly compensate for this limitation. Although "support agreements" can be regarded as a possible solution for eliminating this obstacle, it is not expected that they will be put into practice in the near future, because they clash with the existing legislative framework. Also, their reach would still be very limited.

Naturally, the state has at its disposal a whole arsenal of various types of PPP support. In examining the types of support, we have expressed the view that great caution needs to be exercised. Because of the lack of funding sources, an attempt can be made to attract the interest of the private sector through financial support measures. However, this attempt may have unwarranted fiscal consequences. Hence, the greatest priority at this point of time is finalizing all other elements of the regulatory framework (such as the methodology for the value for money analysis), and focusing on building institutional capacity. If not, there is a significant risk that–for the sake of promoting PPPs–a blind eye will be turned and the "green light" will be given for projects that fail to satisfy the key requirements, and were made attractive primarily due to the excessive use of incentives.

We are of the opinion that it would be advisable, initially, to predominantly have projects providing more than clear value for money.[37] Typically, these are projects investing in existing infrastructure (brownfield PPP projects), or relatively small investment projects. Another key criterion for these projects would be the existing demand for such public services. Although this approach might seem overly restrictive, we believe that one or two negative cases could fully compromise PPPs. The disproportionate use of incentives by such projects could create a significant burden on future budgets, and contribute to the growth of the deficit. As a consequence of such decisions, PPPs could be reduced to a negligible number of projects, in the future as well.

37 We use the same term used in the PPPCL.