

# Public-Private Partnerships: Defusing the ticking time bomb

By Mathieu Vervynckt and María José Romero • October 2017



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## Executive summary

Public-private partnerships (PPPs) are increasingly being promoted as a way to finance development projects. To pave the way for PPPs, donor governments and financial institutions have set up multiple donor initiatives to promote changes in national regulatory frameworks, to provide advice and to finance PPP projects. In particular the World Bank Group (WBG) has played a leading role in shaping the rules in developing countries which allow PPPs to flourish, and has increased its support to PPPs more than threefold, from US\$0.9 billion to US\$2.9 billion, over the period 2002-2012.

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Since 2004 there has been a rapid growth in the value of PPPs in the developing world. Over an eight-year period, investments through PPPs increased by a factor of six: from US\$25 billion to US\$164 billion. After that the trend has been volatile. Although investment in PPPs fell in 2013, they continued to increase in 2014 and in 2015 (US\$104 and US\$118 billion respectively). 2016 saw another decrease to US\$70 billion due to declining investment in developing markets. But increased efforts by MDBs to leverage private financing in both emerging and low income economies indicate a more determined push to reduce the risk for private sector investors to come in.

This briefing builds on Eurodad's previous work on PPPs, including the major 2015 report *What lies beneath*, but focuses specifically on the costs to the public purse of PPPs, and why bad practices generate a false and damaging incentive in favour of the mechanism. It also highlights the powerful role of the WBG in incentivising PPPs, which can be extremely problematic, especially when countries are not adequately alerted to the fiscal risks of PPPs and how to manage them properly. Until the real costs are transparently reported and used to make sensible decisions about whether to use a PPP or a different option to deliver public services, PPPs will continue to be highly problematic.

### **This briefing finds that:**

- The fiscal costs of PPPs can impose large burdens on the public purse. These costs are not just a result of explicit liabilities, as stated in the contractual arrangements, but also arise from non-transparent contingent liabilities (payments required from governments in certain circumstances, such as when the exchange rate of the domestic currency falls, or if the demand falls below a specified level). PPPs have already left lasting negative fiscal legacies in both the global north and south, in countries such as the UK, Portugal, Ghana, Peru and Lesotho.
- PPPs typically suffer from a lack of transparency and limited public scrutiny, which creates greater opportunities for poor decision-making and corrupt behaviour. Lack of transparency – including poor fiscal transparency and opaque decision making processes – frequently leads to a higher cost throughout the PPP cycle. A switch to a presumption of full transparency would bring important benefits, increasing the scrutiny and accountability of the PPP process.
- The way governments record the costs of PPPs in financial statements and budgets creates a false incentive in favour of PPPs. Current accounting practices allow governments to keep the costs and liabilities of PPPs off balance sheet, and thus to circumvent budgetary constraints. In addition, governments typically do not report fiscal commitments for PPPs in financial statements and budgets from the moment those commitments are made, but only when cash transfers occur. This is known as cash-basis accounting, and it means that decision-makers can opt for a PPP based on a budget which does not reflect the total cost over the medium and long term.

- While most of the international PPP standards developed so far advise countries against the false incentives of off-balance sheet budgeting and cash-basis accounting, their influence is limited. Even many European Union (EU) countries have exploited loopholes in the current EU rules and have taken risky off-balance sheet decisions, thus setting a very problematic international example. Ultimately, accounting and budgeting practices remain very country-specific, as countries face differing capacity levels and politicians are not immune to the attraction of keeping true costs hidden. For instance, current orthodoxy encourages a low fiscal deficit, and changing the accounting standards or opting for public investment could have an impact on fiscal deficit figures.
- The WBG is at the forefront of the global push for PPPs. It develops guidelines and frameworks that incentivise the use of PPPs, and lead to unbalanced risk-sharing which favours private investors over governments and citizens (for instance, see concerns raised on the 2017 Guidance on PPP Contractual Provisions). It also sets up and hosts global infrastructure initiatives which privilege private over public financing of infrastructure. Although it collaborates with the IMF on its work highlighting the fiscal risks of PPPs, the vast majority of the WBG's work is directed to spreading the use of PPPs, and woefully inadequate attention is paid to: alerting countries to the fiscal risks of PPPs; tackling the false incentive of PPP accounting; or on evaluating alternatives including the public financing option to fund infrastructure projects.

On the basis of an increasing body of evidence collected over the years by civil society organisations (CSOs) and other stakeholders, Eurodad strongly believes that PPPs would be less favoured than public procurement if a) they were accounted for and budgeted transparently, and b) if the cost-benefit analysis and information relating to public contracting had to be publicly disclosed.

In order to avoid the key problems described in this briefing, the WBG – the world leader in promoting PPPs, and an institution with a development mandate – must reverse course. It must stop favouring PPPs over other alternatives, and accept its responsibility to ensure that it only helps the governments it works with to select the best financing mechanisms, and to emphasise the importance of taking into account the full fiscal implications over the long term and the risk comparison of each option.

Governments that choose PPPs – after comparing other options – also have a responsibility to up their game. The contract value and long term implications of each project must be included in national accounts, rather than being off-balance sheet. Full details of guarantees and contingent liabilities associated with PPPs, and the conditions that will trigger them, and all PPP-related documents should be publicly disclosed. These will allow citizens to have a clear understanding of the fiscal risks involved and will increase democratic accountability.





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## Introduction

Public-private partnerships (PPPs) are being increasingly promoted as a way to finance development projects, including social and economic infrastructure. Donor governments and financial institutions, such as the World Bank Group (WBG) and other multilateral development banks (MDBs), have set up multiple initiatives to promote changes in national regulatory frameworks to allow for PPPs, as well as to provide advice and finance for PPP projects.

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Although the involvement of the private sector in public service provision is not a new policy development, there is currently a high political interest in PPPs as a way of leveraging private finance.<sup>1</sup> PPPs featured prominently in the Addis Ababa Action Agenda, which came out of the 2015 UN Conference on Financing for Development, and are specifically promoted as a “means of implementation” of the Sustainable Development Goals.

There is no universally agreed definition of PPPs. For the purpose of this briefing we define PPPs as long-term contractual arrangements where the private sector provides infrastructure assets and services which traditionally have been provided by government, such as hospitals, schools, prisons, roads, bridges, tunnels, railways, and water and sanitation plants, and where there is some form of risk sharing between the public and the private sector.<sup>2</sup>

Since 2004 there has been a rapid growth in the amount of money invested in PPPs in the developing world. Over an eight-year period, investments through PPPs increased by a factor of six: from US\$25 billion to US\$164 billion. After that the trend has been volatile. Although investment in PPPs fell in 2013, mainly due to a big decline in PPP projects in Brazil and India, they continued to increase in 2014 and in 2015 (US\$104 and US\$118 billion respectively). 2016 saw another decrease in investments through PPPs (US\$70 billion), again down to declining investment in key markets, such as Turkey, India, Brazil, South Africa and Peru.<sup>3</sup> But, the increased efforts by MDBs to leverage private financing in both emerging and low income economies – for example, by the systematic use of the ‘cascade’ approach<sup>4</sup> developed by the WBG – indicate a more determined push to reduce the risk for private sector investors to come in.

This briefing builds on Eurodad’s 2015 report, *What lies beneath*,<sup>5</sup> and focuses on the costs of PPPs. It highlights the relevance of PPP accounting, as there are some practices that generate a false incentive in favour of the mechanism. As Eurodad has previously stressed, some governments keep PPP projects and their contingent liabilities “off-balance sheet,” meaning the true cost of a project is hidden. As a result, many projects have been procured as PPPs simply to circumvent budget constraints and to postpone recording the fiscal costs of providing infrastructure services – practices which end up exposing public finances to excessive fiscal risks.

Finally, we argue that there are some powerful actors, in particular the WBG, which have incentivised the use of PPPs through different initiatives and policy guidelines. The Bank’s leadership have unduly influenced how countries choose to finance social and economic infrastructure projects, without weighting the fiscal costs of PPPs or effectively tackling the accounting bias.

This briefing is structured in three sections. The first section unpacks the costs of PPPs, including hidden costs and the cost of poor transparency. The second section highlights the importance of PPP accounting and the false incentives in favour of PPPs posed by some practices. The third section analyses the controversial way in which the WBG incentivises PPPs. The briefing concludes with some advice to CSOs on more effective campaigning and advocacy.

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# 1. Why PPPs have often proven costly

The cost of PPPs is one of their crucial weaknesses. There is a rapidly growing body of evidence that warns against the different fiscal and public costs of PPPs – explicit, hidden, direct and indirect. Furthermore, lack of transparency around decision making and implementation of PPP projects results in additional costs, whilst conversely an increased level of transparency brings its own benefits. Taken together, these costs often result in a heavy fiscal burden that undermines, in the medium and long term, the state's capacity to support other services. This chapter analyses the different fiscal costs of PPPs and addresses the issue of poor transparency from a cost perspective. As a whole, it makes a case for a thorough and transparent cost-benefit analysis to support the choice of a particular financing mechanism to fund social and economic infrastructure projects.

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## 1.1. The fiscal costs of PPPs

### Explicit costs

These are the explicit payments specified in the contract and are typically spread over the lifetime of the contract. They can be of different types: "viability gap" payments (capital contributions to ensure that a project that is economically desirable but not commercially viable can proceed); "availability payments" (regular payments over the lifetime of the project conditional on the availability of the service or asset); or "output-based payments" (payments made per unit of service).

### Hidden costs

Governments involved in PPPs are typically exposed to a wide range of contingent liabilities, which are hidden to the general public, and also to government officials negotiating the contract, who often do not have the expertise to conduct a thorough risk assessment analysis. Contingent liabilities are financial obligations whose timing and magnitude depend on the occurrence of some uncertain future event outside the control of the government<sup>6</sup> (for example, if the exchange rate of the domestic currency falls or if the demand falls below a specified level). Contingent liabilities create the greatest fiscal uncertainty, they are kept "off-balance sheet", and are by their very nature non-transparent. There are two different types of contingent liabilities:

- **Explicit contingent liabilities:** These come as a result of public guarantees issued to offset the risks to private firms which are partners in PPPs – risks including exchange rate fluctuations, inflation, prices and demand for the given service, among others. Governments are often put in a position where they have to guarantee above-average income streams to attract private investors. The list of guarantees offered to firms in order to make PPPs look 'bankable' is substantial. They can include loan repayments, guaranteed rates of return,<sup>7</sup> minimum income streams,<sup>8</sup> guaranteed currency exchange rates and guaranteed compensation should new legislation affect an investment's profitability.<sup>9</sup> Guarantees are more likely to be triggered in times of economic malaise or crisis (for instance, when the demand for a certain service goes down due to lower economic activity) rather than when the economy is doing well, but they can also be triggered as a result of poor planning (see Box 1 below with the case of Portugal). The experience shows that accurate demand projections are crucial for cost certainty, but unfortunately there are weak incentives for rigorous analysis on both the private and the public sector sides. Some researchers have stressed the "optimism bias" of PPPs, as a strategic overestimation of demand is common practice.<sup>10</sup> The example of PPP-run motorways in Germany emerged in August 2017, just in the run-up to the elections: a consortium operating the PPP 'A1 Mobil', a PPP-run motorway between Hamburg and Bremen, was on the verge of insolvency and wanted to sue the state for damages amounting to €778m. The company gets money from the German toll for trucks, but due to the financial crisis, traffic was below expectations.<sup>11</sup> Furthermore, weak governance and institutional frameworks, or limited transparency and public scrutiny of contract negotiations, encourages decision-makers to take on ill-advised, high-risk guarantees. In addition, the use of public guarantees has the potential to encourage private investors to manage risks poorly or conduct poor due diligence.
- **Implicit contingent liabilities:** These are highly unpredictable and often do not become apparent until after a PPP project has run into trouble. They depend to some extent on public expectations of success or pressure from interest groups, and are triggered when PPPs fail to perform as promised. For instance, as PPPs often concern strategically significant social and economic sectors, the public sector often ends up bailing out the project. In some more problematic cases, it bails out the private sector company instead of paying the political and social costs of disrupted or discontinued services. This in turn results in private debts being shifted to the public sector.

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## Direct costs

These are the costs of building and running the service provided – construction, design, management, etc. Some of the most relevant direct costs are:

- **Cost of capital:** The cost of financing is usually more expensive for PPP projects than for public sector works. The reason is simple: national governments can usually borrow money at lower interest rates than private sector companies, because lending to private companies is riskier than to governments, with their lower risk of default. In the case of the UK, a 2015 review by the UK's National Audit Office (NAO) found "that the effective interest rate of all private finance deals (7%-8%) is double that of all government borrowing (3%-4%)."<sup>12</sup> In other words, the costs of financing of PPP-operated services or infrastructure facilities were twice as expensive for the UK public purse than if the government had borrowed from private banks or issued bonds directly.<sup>13</sup>
- **Rate of return:** Private sector companies are expected to make a profit on their investment. In the case of 'government-funded PPPs', the need for a private company to make a profit increases the cost of the project to the public purse, whilst in the case of 'user-funded PPPs', it increases the cost to users (see section 2).<sup>14</sup> Due to commercial confidentiality issues, there is little information available on the returns made by private investors in PPP projects, but the UK's NAO 2012 review indicates that the expected return is between 12-15 percent at the point contracts are signed. However, private investors who invest in the project from the start might sell their shares in a project soon after construction is completed, allowing them to earn rates of return of 15-30 percent per year. In the case of projects developed in the global South, the returns to capital required by investors are higher than in developed countries, due to higher perceived risks. For instance, a Counter Balance report noted that in such cases, investors expect annual returns of 25 percent or more.<sup>15</sup>
- **Construction cost:** Construction costs are generally higher for PPPs than for traditional public procurement because of the explicit recognition and pricing of construction risks transferred to the private partner. Empirical research on construction contract prices comparing the cost of 227 new road sections financed by the European Investment Bank (EIB) between 1990 and 2005 across 15 European countries (of which 65 were PPPs) estimates "the ex-ante cost of construction is 24% higher through PPPs than through traditionally public procurement, all other things held equal."<sup>16</sup>

## Indirect costs

PPPs entail different indirect costs, including transaction costs and renegotiation costs. Limited competition can also be seen as an indirect cost.

- **Transaction and other related costs:** PPPs are very complex arrangements with high costs associated with negotiating, preparing, and managing the projects. These can be considerable as a result of, for example, the fees from legal and financial advisors to structure and negotiate the deal. For instance, as the Financial Times reported in 2011, "lawyers, financial and other consultants have earned a minimum of £2.8bn and more likely well over £4bn in fees over the past decade" to implement the 700 projects that successive governments acquired as PPPs.<sup>17</sup> Other estimates suggest that "these costs can reach 10% of the total cost of the project."<sup>18</sup> High transaction costs of setting up the contractual structure and carrying out adequate due diligence can make it unattractive for small projects. If a PPP is the preferred financing mechanism, it is expected that larger projects will be pursued. While delays are common in the construction phase of both public and private sector projects, they are particularly problematic in larger scale projects, and they can cause both cost overruns and benefit shortfalls.<sup>19</sup> At the same time, PPPs constrain the capacity of governments, as it is generally difficult to build flexibility into PPP contracts, and changes necessarily mean significant extra costs. In practical terms, this limits the capacity of governments to enact policy that might affect particular projects.<sup>20</sup>
- **Renegotiation costs:** The final cost of the project can increase as a result of contract renegotiation. In most cases, the renegotiation process entails important costs for the public sector due to the lack of competition and transparency, and the privileged position of the private sector company. According to staff from the IMF Fiscal Affairs Department (FAD), 55 percent of all PPPs get renegotiated, on average every two years, and in the majority of cases, these result in an increase in tariffs for the users.<sup>21</sup> In addition, empirical research found that the associated costs of renegotiation ranged from 3-15 percent of the investment.<sup>22</sup>
- **Limited competition:** The different costs mentioned above also mean that few companies have the capacity to apply for projects. This reduces governments' choice and competition in tendering processes. Limited competition among companies can increase the final project cost and increase the opportunities for corrupt behaviour.<sup>23</sup> In addition, limited competition creates increased risk for the public sector because companies are large and powerful enough to take on the regulators in the case of conflict and forced contract renegotiation on more favourable terms.<sup>24</sup>

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### Box 1: Portugal and the fiscal impact of PPPs

Since the early 1990s, Portugal has replaced traditional procurement with large PPP contracts to meet ostensibly pressing infrastructure needs. Portugal was a pioneer of the PPP boom in Europe. Relative to its gross domestic product (GDP), Portugal has had the highest cumulative investment in PPPs in the EU over the past decade. It started in the run up to the 1998 World Exhibition in Lisbon, when an additional bridge over the Tagus River was to be built.

However, it soon turned out that infrastructure needs were largely overestimated. Long sections of expensive motorways built through PPP contracts never attracted the predicted traffic volume, forcing the government to compensate the private partner for the lack of users – leading to fiscal problems. According to an IMF issue paper published in 2013, “the deterioration of the fiscal accounts was accompanied by aggressive off-budget spending, leading to a buildup of substantial contingent liabilities. The most important of these off-balance transactions was capital spending implemented through PPPs (15 percent of GDP in cumulative investment at 2012 prices, substantially above international practice)...” (emphasis added).<sup>25</sup>

Portugal became one of the most indebted countries in the euro area and had to request bailout loans from the Troika (the European Central Bank, the European Commission, and the IMF). The 2011 adjustment programme agreed with the Troika devoted a special chapter to PPPs, with an explicit demand to renegotiate some of the old PPP contracts and a temporary ban on Portugal entering into new PPP agreements.

In October 2014, the IMF fiscal transparency evaluation for Portugal also mentioned that “PPPs are still a significant source of fiscal risks in Portugal (...) the estimated present value of central government’s recorded financial commitments was about 6 percent of GDP at end-2013”, while “contingent liabilities, related to law suits, which on December 31, 2012, amounted to €2.1 billion (1.3 percent of GDP).” Worryingly, the IMF found that “little or no information is provided on the 75 central government concessions or on PPPs at the local level. (...) The total investment value of [these] amount to around €21.3 billion (13 percent of GDP).”<sup>26</sup>

While PPP supporters acknowledge (most of) the financial costs stated above, they argue that these are justified in terms of efficiency gains. In some cases the efficiency gains come from improvements in design, construction and operations. There are some studies that refer to these gains but, in general, efficiency gains depend on the sector, the type and size of projects, the private sector increasing capital investment as agreed in the contract, and the regulatory and governance environment of the country.<sup>27</sup> Importantly, as IMF staff highlight, “If the company is more efficient than the government, then the PPP NPV [net present value] should be lower than that of the government procurement. However, some other factors may offset such efficiency gains (...). This includes company profits, typically higher company interest costs and PPP transaction costs.”<sup>28</sup> This raises red flags and makes a very strong case for a thorough analysis of the cost and benefits of PPPs.

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### 1.2. The costs of poor transparency

PPPs typically suffer from lack of transparency and limited public scrutiny, which can lead to poor decision-making due to less oversight, and can increase opportunities for corrupt behaviour. On the one hand, there is usually a high cost associated with poor transparency (including poor fiscal transparency and opaque decision making processes) throughout the PPP cycle, and on the other hand transparency itself also brings important benefits as it increases democratic accountability of the PPP process.

Although there is increased lip-service paid to the importance of transparency, PPPs are often regulated by commercial and competition laws, where confidentiality clauses prevail. For instance, a 2011 examination of PPP projects in the UK by the Committee of Public Accounts of the UK Parliament found that “transparency on the full costs and benefits of projects to both the public and private sectors has been obscured by departments and investors hiding behind commercial confidentiality”.<sup>29</sup>



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The lack of transparency throughout the PPP cycle can increase the fiscal costs of PPPs in different ways. Many countries do not publicly disclose full details of guarantees and contingent liabilities associated with PPPs, nor the conditions that will trigger them, which is also vitally important for public scrutiny. This makes fiscal policy decisions less informed and encourages governments to go ahead with projects even when they can create fiscal problems in the future. It also means that citizens are left in the dark about their government's real fiscal vulnerability.

In addition, opaque deals often entail greater opportunities for corrupt behaviour, which increases the costs of the projects. This has been the case in developed and developing countries alike. In Australia, an Independent Commission Against Corruption found that ministers at the state level unlawfully interfered with a decision on a water PPP with the aim of siphoning off AUS\$60m of state money to one of the ministers, his family, and associates.<sup>30</sup> The Brazilian construction giant, Odebrecht, paid bribes to government officials in a dozen of countries throughout the whole continent. *The Economist* revealed in early 2017 that the main method for the company to win contracts was to make low bids and "then corruptly secure big increases in costs through addenda – in some cases when the ink on the contract was barely dry". According to *The Economist*, "the cost of a [PPP] road linking Brazil and Peru rose from \$800m to \$2.3bn through 22 addenda."<sup>31</sup>

Transparency throughout the PPP cycle brings important benefits. It is essential to allow for democratic accountability of the implementation process, because more public scrutiny means better decision making. It empowers government officials to put pressure on private sector companies to comply with contract clauses, and discourages corrupt practices. Transparency enables citizens and parliaments to understand who will pay what to whom, when, and from which budget.

In practical terms, transparency means full disclosure of contracts and of pre-studies, bid documents, and performance evaluations, among others. The Open Contracting Global Principles were developed by the Open Contracting Partnership in October 2013, in consultation with governments, the private sector and civil society organisations. They state that the proactive disclosure of documents and information relating to public contracting, including PPPs, is key to enabling "meaningful understanding, effective monitoring, efficient performance, and accountability for outcomes".<sup>32</sup> Importantly, the OECD<sup>33</sup> and IMF<sup>34</sup> have also called for the disclosure of costs and contingent liabilities of PPPs.

Transparency is also a significant component of accountability: without information, governments cannot be held accountable. A broad range of stakeholders – including trade unions, local communities and non-governmental organisations (NGOs) – should be encouraged to participate actively throughout the project cycle, as unlike the main investors, they often lack access to information or influence on company decisions. These are relevant stakeholders who should be involved at an early stage to understand the pros and cons of PPPs and to inform governments' decisions. This demand does not only come from CSOs. The OECD also states in its principles for public governance of PPPs that "popular understanding of PPPs requires active consultation and engagement with stakeholders as well as involving end-users in defining the project and subsequently in monitoring service quality".<sup>35</sup> In practice, however, proper stakeholder consultations do not always take place.

As a result of all the costs mentioned in this section, PPPs have already left lasting negative fiscal legacies in both developed and developing countries. For instance, according to the UK newspaper *The Telegraph*,<sup>36</sup> Private Finance Initiative (PFI – the UK name for PPP) hospitals in the United Kingdom cost the National Health Service £2 billion every year, which has raised concerns of "wasted and misdirected spending." Other countries such as Ghana, Tanzania, Uganda,<sup>37</sup> Peru<sup>38</sup> and Lesotho have also been affected by the costs of expensive PPP projects. In the case of the latter, Oxfam and the Lesotho Consumer Protection Association found that one PPP hospital swallowed up half of the country's health-care budget while giving a high return of 25 percent to the private sector provider.<sup>39</sup>

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## 2. PPP accounting – how some practices generate a false incentive

Given the higher costs associated with PPPs, the key question is why decision-makers often prefer PPPs over traditional public investment. In most cases, this has a lot to do with the way governments record the costs of PPPs in financial statements and budgets, as opposed to the way in which public investment is recorded. The crux of the issue is whether or not PPPs assets and liabilities are recognised in governments' accounts, and if they are, when this happens. In practice, "off-balance sheet" accounting generates a false incentive in favour of PPPs, as governments select PPPs not for efficiency reasons, but to circumvent budget constraints. Using cash-basis accounting also creates a bias in favour of using PPPs. This section unpacks PPP accounting and its implications for PPPs. It also includes the relevant highlights in relation to international accounting and reporting standards for PPPs, with the objective of identifying critical loopholes.

To start with, it describes how PPPs are often structured. Usually PPPs are operated via special purpose vehicles (SPVs) financed by debt and equity. These are legal entities set up and used by companies or governments, typically to isolate them from too much financial risk. In the case of PPPs, especially large infrastructure projects, SPVs are often used to raise capital, to share and minimise the risks among different investors and to operate the contract. When a PPP project is undertaken by an SPV, the impact on government accounts will depend on whether the government classifies the SPV as a public or a private entity. This in turn depends on the government's assessment of how exactly the risks are shared between different parties involved in the SPV, and who controls the assets that have been transferred to the SPV. If the SPV is classified as private, the assets, liabilities and expenses are kept off the government balance sheet.

When analysing accounting for PPPs in government accounts, it is important to make a clear distinction between funding and financing of a PPP project. Financing (the money needed to complete the project) can be done through debt and equity instruments, but it does not affect the government accounts. Funding (i.e. the money needed to repay the financing, over the lifetime of the project) is the source of the private sector revenue, and if the asset is considered to be controlled by the government, it will have an impact on the deficit and debt of government accounts. As the literature on PPPs clearly shows, public infrastructure can only be funded either by the users of the infrastructure (e.g. paying a toll charge to use a bridge) or by the government using taxpayers' money. As a result, PPPs can be classified as "user-funded" and "government-funded", although the boundaries between these categories may be blurred.

- In **user-funded PPPs**, the private partner is allowed to charge the public for using the facility, generally through paying a fee, which can be supplemented by subsidies paid by government. The fees reimburse the private partner for the cost of building and operating the facility, which can revert back to the public sector at the end of the contract period (usually 20 years or more).
- In **government-funded PPPs**, the private sector company provides and administers infrastructure for the public authority. The payment of the private partner comes only from regular payments by the public partner based on the level of service provided. The payments can depend on the asset or service being available at a contractually-defined quality, or on the services delivered to users such as a 'shadow toll' road, which is free for users, but where the governments pays a fee per driver to the operator. The PFI programme in the UK is an example of this.<sup>40</sup>

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### 2.1. Accounting methods and their implications for PPPs

Accounting methods are the means of recording when income is received and expenses are paid. There are two main types of accounting methods: cash-basis accounting and accrual accounting. The former means that expenses are only recognised once an actual cash transfer takes place. By contrast, the latter records expenses as soon as the decision has been made to purchase an item. For example, if you buy a car under cash-basis accounting, the expense would only be recorded once the actual cash has been transferred. Under accrual accounting, on the other hand, the expense would be recorded from the moment you signed the contract to purchase the car, irrespective of the timing of the upcoming cash transfer.

Which method a country uses has particular implications for the accuracy of that government's accounts and budgets. Accrual-based recording of costs takes into account upcoming capital repayments over the lifetime of a PPP project to which the government is committed. Cash-based systems, however, do not require expenditure or debt to be recorded in the early stages of the PPP project cycle, during which time the private partner spends cash to construct the project. According to experts from the IMF's FAD, "the discrepancy between cash and accrual accounting of PPPs can be substantial, particularly at early stages of the project cycle." And they add that "cash-based systems (...) can result in an underestimation of the medium and long-term impact of PPPs".<sup>41</sup>

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Accruals can be applied to both accounting and budgeting practices. Accrual accounting means that the costs of PPPs are recorded in financial statements, whereas accrual budgeting refers to the costs being recorded in a government's budget. Accrual accounting can increase transparency around the true cost of government and enhance decision-making, but it is the budget which typically serves as the key financial management document in the public sector – governments are held accountable over their budgets as they are approved by the parliament. Accrual accounting and budgeting can, therefore, be seen as a package deal.

While there are particular advantages to accrual accounting and budgeting, it is still unsuited for many countries: it can be too complex, and requires a high level of technical expertise. In addition, transitioning from cash to accrual takes time and resources. However, the basic principles of accrual can and should be used to improve the decision making processes, fiscal transparency and management of fiscal risks around PPPs. For instance, the future costs to governments should be weighed against alternatives at the time of selection – if not, bad decisions will be made.

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## 2.2. The limited influence of international standards on PPP accounting

Many countries use, or are informed by, accounting standards and guidelines for PPPs set by international institutions, including the International Public Sector Accounting Standards Board (IPSASB), the IMF, the OECD, and the European Commission. While most of the standards developed so far advise countries against the false incentives of off-balance sheet accounting and cash-basis accounting, ultimately accounting and reporting standards remain a sovereign affair. Historically, accounting standards in the public sector have been set by a country's Minister of Finance, who may face incentives to follow alternative models – for example, they are generally encouraged to operate with a low fiscal deficit.

### International Public Sector Accounting Standards Board (IPSASB)

The IPSASB develops accounting standards and guidance for use by public sector bodies. The Board is nominated by stakeholders including members of the International Federation of Accountants, international organisations, government institutions, and the general public. The International Public Sector Accounting Standard 32 (IPSAS 32), introduced in 2011, is the current international public sector accounting standard for PPPs. It defines when PPP assets and liabilities should be recognised, assuming a government is following IPSAS accrual accounting standards.

In those cases where the government controls or regulates the provision of the service, and if the ownership of the asset is returned to the public sector at the end of the arrangement,<sup>42</sup> IPSAS 32 establishes that PPP projects should be considered public and should therefore be reflected in the main fiscal aggregates (fiscal deficit and debt). As a result, according to IPSAS 32, the assets and liabilities for both government-funded and user-funded projects should be recorded on the government balance sheet – an approach similar to traditional government procurement which would reduce bias in favour of PPPs.<sup>43</sup> Furthermore, the IPSASB argues that a government is ultimately responsible for its country's public services, even for user-funded projects, because when user-funded projects encounter difficulties (as frequently happens), it is often the government that takes over those projects and consolidates their assets and liabilities onto its balance sheet. In practice, improving the balance sheet accounting (of assets and liabilities) contributes to improving the budgeting (of income and expenditure) as budgets will become more transparent and accurate.

In addition, IPSAS standards require governments to recognise contingent liabilities (although only if the underlying event is more likely than not to occur and the amount of the obligation can be reliably measured). If this is the case, the current net value of the expected cost of the contingent liability should be recognised as a liability when the contract is signed.<sup>44</sup>

### IMF

The IMF is one of the leading institutions when it comes to defining how PPPs and public investment should be reported in government finance statistics. The IMF has developed its own manuals, such as the Government Finance Statistics Manual (GFSM) and the Guide on Public Sector Debt Statistics, but the institution has also developed new fiscal tools for countries to use in their decision-making process on PPPs.

#### *Government Finance Statistics Manual (GFSM)*

The first GFSM was published in 1986 and was based on the cash-based accounting concept. This changed in 2001, when the Fund adopted the accrual-based GFSM as the new framework for collection and dissemination of government finance statistics. The latest GFSM, published in 2014, continues to follow this approach. More specifically, it "recommends disseminating fully integrated flows and stock positions, recorded on an accrual basis, while maintaining cash-flow data to allow an assessment of the liquidity constraints of government".<sup>45</sup> Under the GFSM, PPP assets are accounted for in the government's balance sheet if the government bears most of the project's risks and rewards. This assessment of whether a PPP contract creates assets and liabilities for the government is a similar approach to that prescribed by IPSAS 32, and therefore has a similar impact on fiscal deficit and debt.<sup>46</sup>

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The GFSM also recognises that the “implementation of the fully integrated system described in the manual will take some time and will need to progress at a pace determined by the differing needs and circumstances of the country involved. In particular, many countries will need to revise their underlying accounting systems to reflect the accrual basis of recording and revised classifications”.<sup>47</sup>

Significantly, the GFSM also lays out how to account for public investment – an important consideration when comparing the impact on main fiscal aggregates of PPP projects to that of traditional public investment, particularly at a time when a low fiscal deficit is highly encouraged. According to the 1986 manual, public investments are similar to “expenditure,” resulting in a direct impact on the fiscal deficit. This consideration was changed in 2001: “Purchases of nonfinancial assets do not affect net worth and are not considered expense transactions. The term ‘expense’ replaces ‘expenditure’ from the GFSM 1986 because it is more closely associated with the accrual basis of recording and indicates that transactions in nonfinancial assets are excluded.” However in many countries, accounting for public investment continues to be guided by the GFSM 1986, which in practice implies a strong incentive against public investment because a high fiscal deficit can have an impact on the country’s investment grade.

#### ***PPP Fiscal Risk Assessment Model (P-FRAM)***

The IMF’s FAD is actively working on PPPs and its fiscal risks. In collaboration with the WBG, the IMF FAD has developed the PPP Fiscal Risk Assessment Model (P-FRAM). P-FRAM is an analytical tool to assess the potential fiscal costs and risks arising from PPP projects. It evaluates just one PPP project at a time (as such, it does not provide information on a country’s PPP portfolio), which can be either an existing PPP project at different stages of the project cycle, or a project idea. Specifically, the tool has been developed to quantify the macro-fiscal implications of PPP projects, such as their impact on a country’s fiscal deficit, its gross and net debt, and the stock and flows of a government’s contingent liabilities. Potential users of P-FRAM are not only IMF and World Bank experts on PPPs, but also government officials working on PPPs and fiscal risks in ministries of finance. P-FRAM also provides a framework to identify and evaluate fiscal risk, to discuss appropriate mitigation measures, and to prepare an action plan to implement these measures.<sup>48</sup>

P-FRAM bases itself on the GFSM 2014 and IPSAS 32, although it adapts IPSAS 32 to cash accounting, allowing users to see how a PPP is reflected in both accrual and cash accounting. The five-step decision-tree of the P-FRAM includes:<sup>49</sup>

- Who initiates the project?
- Who controls the asset – the government or private partner?
- Who ultimately pays for the asset? Three funding alternatives are considered:
  - the government pays for the asset using public money (for example, through availability payments);
  - the government allows the private sector to collect fees directly from users of the asset (for example, through tolls);
  - a combination of the first two alternatives.
- Does the government provide additional support to the private partner? For instance, guarantees, equity injections, or tax amnesties?
- Is there any additional support provided by government? This collects information on firm and contingent liabilities (for instance, debt guarantees and minimum revenue guarantees). Other methods of government support could include subsidised prices for asset-related services, equity injections or tax amnesties.

P-FRAM was launched during the World Bank and IMF’s 2016 Spring Meetings and is currently being piloted in Jamaica, Honduras, Chile, New Zealand, Sri Lanka, Colombia, Uruguay, Cambodia, Thailand, Serbia and Georgia. A report summarising the results is due to be presented by the World Bank and IMF annual meetings in October 2017.

#### **OECD**

The OECD’s Recommendation of the Council on Principles for Public Governance of PPPs was released in 2012.<sup>50</sup> It is aimed at OECD member states, whilst simultaneously it “invites non-members to take account of and adhere to this Recommendation.” One of its broad principles is to “Use the budgetary process transparently to minimise fiscal risks and ensure the integrity of the procurement process.” As part of this, the OECD states that: “budget documentation should transparently disclose all information possible regarding the costs and contingent liabilities of the PPP. The information should include what and when the government will pay, and full details of guarantees and contingent liabilities. The payment stream from government under the PPP contract should be highlighted, particularly if it is back loaded. Preferably the information should be disclosed at the same time as the results of the long-term fiscal analysis that shows the long-term effects of the stock and new flow of PPP contracts.”

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In addition to these principles, the OECD also encourages its member states to adopt accrual accounting and tracks their implementation efforts. However, the recent OECD report on accrual practices and reform experiences in OECD countries concludes that “the direct adoption of international accounting standards such as International Public Sector Accounting Standards (IPSAS) or International Financial Reporting Standards (IFRS) by national governments remains very low. Countries seem to favour national standards for accommodating a number of specific deviations [such as PPPs]”. It goes on to note that among OECD countries, 57 percent use national standards and 28 percent use national standards that are based on IPSAS.<sup>51</sup>

### **The European Commission’s Eurostat**

EU member states are required to follow the European System of Accounts (ESA). Eurostat, the EU’s Statistical Office, aims to make sure that member states are indeed applying ESA “in order to gather reliable and comparable statistics on the debt and deficit position of Member States”.<sup>52</sup> Since September 2014, member states must comply with ESA 2010. This means that countries need to record a PPP asset either as a wholly government asset or a wholly non-government asset.

According to the European PPP Expertise Centre (EPEC), “the purpose of the Rules is to allocate a PPP to the balance sheet of the economic owner of the PPP asset, which is the party that bears most of the risks and has the right to most of the rewards associated with the asset”.<sup>53</sup> EPEC notes that “an excessive focus on off government balance sheet recording can be at the expense of sound project preparation and value for money and may push public authorities to use PPPs where not appropriate”. In addition, EPEC admits that PPPs can create an “affordability illusion” which “tends to be exacerbated when a project is found to be off balance sheet. The fiscal liabilities that arise from PPPs can have a detrimental effect on the relevant country’s fiscal sustainability and so they should be managed properly”.<sup>54</sup> ESA 2010 also recommends that “flows shall be recorded on an accrual basis; that is, when economic value is created, transformed or extinguished, or when claims and obligations arise, are transformed or are cancelled”.<sup>55</sup>

However, ESA 2010 also includes some controversial rules. For example, ESA 2010 argues that “the risks and rewards are with the operator if the construction risk and either the demand or the availability risks have been effectively transferred”.<sup>56</sup> In other words, if the government only bears the demand risk and not the availability risk – or vice versa – it would still be allowed to keep the PPP off balance sheet. This approach has generated strong opposition from the IMF, which interprets Eurostat’s decisions as “problematic.” In a paper published in 2004, the IMF argued that “since the private sector typically bears most construction risk and availability risk, the decision is likely to result in the majority of PPP assets being classified as private sector assets, even though the government will bear most demand risk”.<sup>57</sup>

Although in theory EU member states are required to follow ESA, in practice many countries have interpreted the rules in a way that benefits their short-sighted political interest, which in turn sets a very poor example internationally. In response, in September 2016 the European Commission and the EIB published a guidance paper on the Eurostat treatment of PPPs. The paper aims to give public and private stakeholders a clear idea of the potential fiscal impact of PPPs on governmental budgets, and to clarify some ambiguities in order to avoid inappropriate or unethical accounting. The guide has had some immediate consequences for EU member states such as Belgium, which will have to report the “Oosterweel” mega-infrastructure project in the city of Antwerp on the books – leaving no room for interpretation whatsoever.<sup>58</sup>



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### 3. The role of the World Bank Group in incentivising PPPs

The WBG has been playing a leading role promoting PPPs by trying to create a favourable environment in developing countries for PPPs to flourish. In its 2013 strategy, the WBG announced that it intended to “increasingly promote public-private partnerships” and “to consider PPPs as ‘cross-cutting solutions’”.<sup>59</sup> As part of this strategy it created the PPP Unit, formally called the “PPP Cross-cutting solutions area”, which in 2017 was renamed as “Infrastructure, PPP and Guarantees Group”.<sup>60</sup>

The WBG leadership is the driving force behind the rise of PPPs as a policy option to fund infrastructure projects. It has worked to guide policy reforms and has provided finance to PPP projects. Over the period 2002-2012, WBG support to PPPs increased more than threefold, from US\$0.9 billion to US\$2.9 billion.

The WBG intervenes at different levels and targets both public and private sector actors. It works upstream to prepare the policy and regulatory framework, which mostly aims at sector reform, and downstream on finance and the execution of projects. Most of the upstream work is provided by the World Bank<sup>61</sup> and complemented by the PPP Unit, and the Public Private Infrastructure Advisory Facility (PPIAF). Downstream work is carried out by the Bank’s private sector arm, the International Finance Corporation (IFC), and the Bank’s political risk insurance arm, the Multilateral Investment Guarantee Agency (MIGA). The division of upstream and downstream work does not, however, prevent the serious risk of conflict of interest arising from the advisory role of the IFC, which advises national and local governments on how to improve their ‘investment climate,’ whilst at the same time supporting private sector companies to do business there.<sup>62</sup> Table 1 (below) provides additional information on the different ways in which the WBG has been incentivising PPPs.

The initiatives listed in Table 1 demonstrate that the WBG has devoted significant effort to incentivising PPPs, whilst neglecting the need to alert countries publicly and loudly on the fiscal implications of PPPs, and failing to promote the public financing option to fund infrastructure projects. The launch of the “cascade” approach in April 2017 (whereby the WBG “first seeks to mobilize commercial finance, enabled by upstream reforms where necessary ... Where risks remain high, the priority will be to apply guarantees and risk-sharing instruments,” to lower the risk for private sector investors, and “only where private financing of projects is not possible, will official and public resources be applied”<sup>63</sup>) also indicates that the Bank will focus on “enabling policy and regulatory environments and on de-risking the private sector’s entry into these environments.” In other words, the Bank will focus on changing the risk-reward calculation in specific countries, sectors and projects in order to attract investors.

CSOs have raised many concerns about the active role of such a powerful institution in support of PPPs. One overarching concern is that an unbalanced risk allocation favouring investors’ interests over those of governments and citizens is being promoted via many different tools and initiatives. To take just one example, the Heinrich Boell Foundation has pointed out to the excessive level of risk that the 2017 Guidance on PPP Contractual Provisions places on governments. According to its legal analysis, it compromises the state’s “right to regulate” in the public interest in order to protect its human rights and the environment.<sup>64</sup>

These concerns are also based on the points raised in 2014 by the WBG’s Independent Evaluation Group (IEG). In the evaluation of the WBG support to PPPs, the IEG indicated that strategic advice from the WBG had overlooked key considerations relating to the fiscal management of PPPs. The IEG found no evidence to support the World Bank’s advice that private sector involvement (in the form of a PPP) was the best option given the relevant country-level circumstances. According to the IEG, “the WBG’s approach to PPPs has been based on the assumption that involving the private sector is a good thing (...) public sector comparators – systematically comparing PPPs against the public sector for value for money to justify private sector involvement – were not a part of the WBG activities”.<sup>65</sup> Moreover, the WBG has not paid enough attention to the contingent liabilities of PPPs. At the project level, these are “rarely fully quantified”<sup>66</sup> and help to assess them has only been provided if requested by the government.

While the WBG has collaborated with the IMF FAD to develop the P-FRAM, overall its work on fiscal management and accounting for PPPs is still limited, and there is no clear provision in its operational guidelines to conduct fiscal impact assessments for each and every project supported by the Bank. Through its Framework for Disclosure for PPP Projects, the WBG advocates for transparency and urges governments to be open about PPP risk allocations, payment mechanisms, fiscal commitments and contingent liabilities. However, this is only part of the story – CSOs participating in the framework’s consultation process specifically requested the disclosure of other key financial information such as a thorough cost-benefit analysis of PPPs, as well as contracts and monitoring reports, which are essential to allow for democratic accountability of the whole PPP process.<sup>67</sup> Unfortunately, however, these elements were omitted by the WBG from the final framework document.

**Table 1:** Overview of WBG initiatives on PPPs

<b>Developing policy guidelines and frameworks</b>	<p>During the last few years, the WBG has served as the G20's go-to agency on PPPs by producing several reports on the issue. These include a PPP Reference Guide (two versions of which have been launched), a Project Checklist for PPPs, a Framework for Disclosure for PPP projects, and a Report on Recommended PPP Contractual Provisions (of which two versions have been launched, the latest in 2017). They have also developed other advice for governments – for example, the PPP Project Preparation Status Tool, the Infrastructure Prioritization Framework, draft Guidelines for the Development of a Policy of Managing Unsolicited Proposals in Infrastructure Projects, and tools for specific sectors such as transport and water. The Group also hosts the PPP Infrastructure Resource Centre, which is an online repository of sample legal materials (contracts, laws and regulations on PPPs), and the PPP Knowledge Lab, a resource for practitioners in procuring and implementing PPPs. It has also published reports stressing the need to support PPPs with public guarantees and subsidies and setting out a framework designed to encourage governments to undertake more and better PPPs. Finally, in March 2017 the WBG, IMF and the African Development Bank prepared a joint report setting out the G20 Compact with Africa (CwA) Initiative, which “provides a framework for boosting private investment and increasing the provision of infrastructure in Africa”.</p>
<b>Hosting global infrastructure initiatives and platforms</b>	<p>The WBG gathers and mobilises MDBs and investors around infrastructure finance and the use of PPPs as a financing mechanism. Since 2014 the WBG has hosted the Global Infrastructure Facility (GIF), a partnership of governments, MDBs, private investors, and financiers, which is “designed to provide a new way to collaborate on preparing, structuring, and implementing complex projects that no single institution could handle on its own.” In 2016 the WBG hosted the first Global Infrastructure Forum, set up by the United Nations Addis Ababa Action Agenda, and committed to serving as the secretariat of the Global Infrastructure Connectivity Alliance, which was launched at the China-led G20 summit in September 2016.</p>
<b>Promoting changes in the regulatory and institutional framework for PPPs</b>	<p>The WBG promotes specific changes to national regulatory frameworks to allow for PPPs. These are included in the policy conditionalities attached to Development Policy Loans (DPLs), and have impacts in different national sectorial policies such as tax, environmental, social and land tenure policies.</p>

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## 4. Conclusion

PPPs are being increasingly promoted as the way to finance development projects. Donor governments and financial institutions, with the WBG at the forefront, have set up multiple donor initiatives to change regulatory frameworks, as well as providing advice and finance related to PPP projects. This push in favour of PPPs is clearly reflected in the amount of money invested in PPPs over the last decade, but also in how the agenda of governments and institutions is being shaped.

This briefing shows that PPPs have proven costly for the public purse. PPPs frequently lead to significant negative fiscal impacts. These result not only from direct liabilities as stated in the contractual arrangements, but also from non-transparent contingent and implicit liabilities, and even from opaque deals which increase the opportunities for poor decision-making and corrupt behaviour. The costs of PPPs have left lasting fiscal legacies in both developed and developing countries, including the United Kingdom, Portugal and Lesotho.

This briefing also shows the importance of PPP accounting, as some accounting practices – such as keeping PPPs off balance sheet, thereby hiding their costs – generate a false incentive favouring PPPs over traditional public procurement. In addition, some countries also use cash-basis accounting, thereby underestimating the true fiscal impact of PPPs, particularly in the medium to long term. While some international institutions, such as the IMF and the IPSASB, have developed standards and frameworks to encourage on-balance sheet accounting for PPPs, it remains questionable whether they have a real impact on governments' decisions, because many countries are under pressure to show a low fiscal deficit.

Finally, this briefing points to the problematic role of the WBG, which through its advice and training is a world leader in incentivising the use of PPPs. The recent launch of the “cascade” approach, which favours mobilising private over public finance on the basis of ‘de-risking’ private investors’ activities, has raised further warning flags. One overarching concern about the role of the WBG is that it in effect promotes unbalanced risk allocation, favouring investors’ interests over those of governments and citizens. This must stop.

We argue that PPPs would be less favoured over public procurement if they had to be transparently accounted and budgeted for, and if information related to public contracting had to be publicly disclosed.

In order to avoid the key problems described in this briefing, the international community needs the WBG to reverse course. It must stop favouring PPPs over other alternatives, and accept its responsibility to ensure that it only helps the governments it works with to select the best financing mechanisms. This means allowing countries objectively to compare the public borrowing option, or other alternatives, to the true costs and benefits of a PPP over the lifetime of a project, taking into account the full fiscal implications over the long term and the risk comparison of each option.

Governments that do decide to go ahead with a PPP – after comparing other options – also have a responsibility to up their game. The contract value and long term implications of each project must be included in national accounts, rather than being off balance sheet. This kind of responsible fiscal management should be complemented with proactive and public disclosure of full details of guarantees and contingent liabilities associated with PPPs, and the conditions that will trigger them, and all PPP-related documents. These will allow citizens to have a clear understanding of the fiscal risks involved and will increase democratic accountability.

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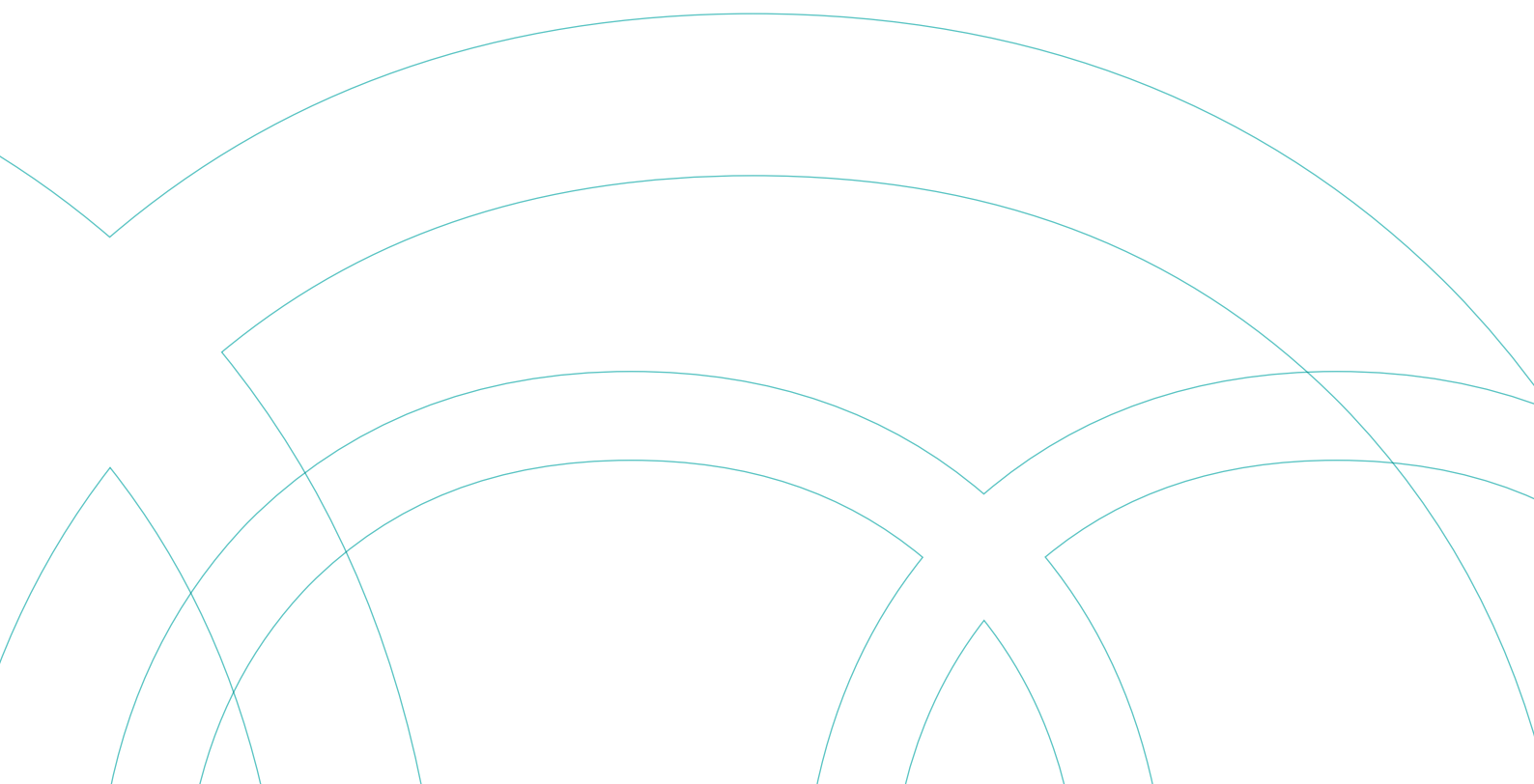


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## Eurodad

The European Network on Debt and Development (Eurodad) is a network of 47 civil society organisations (CSOs) from 20 European countries, which works for transformative yet specific changes to global and European policies, institutions, rules and structures to ensure a democratically controlled, environmentally sustainable financial and economic system that works to eradicate poverty and ensure human rights for all.

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european network on  
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## Contact

Eurodad  
Rue d'Edimbourg 18-26  
1050 Brussels  
Belgium

Tel: +32 (0) 2 894 4640

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