

# Forfeiting by Waiver as an Alternative to Project Financing for the Realization of Public-Private Partnership Projects in Poland

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*Despite growing social infrastructure investment needs, public-private partnership (hereinafter: PPP) is not developing in accordance to expectations in Poland. Only 25% of initiated proceedings conclude in the realization of a contract – a significantly lower rate as compared to other European nations.*

*While there are many potential explanations for the poor development of PPP in Poland, this article showcases the inefficiencies in the project financing model, as well as analyzes the applicability of forfeiting by waiver for Polish PPP projects. It outlines the necessary conditions as well as potential benefits to PPP development should the forfeiting by waiver model be applied comprehensively as a mode of financing for Polish PPP projects. Critical success factors in PPP will be addressed, as well as project risk division and factors influencing the project price.*

**Keywords:** public-private partnership, project financing, forfeiting by waiver, PPP barriers in Poland, public procurement.

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## Forfeiting przez zrzeczenie jako alternatywa finansowania projektu w celu realizacji projektów partnerstwa publiczno-prywatnego w Polsce

*Pomimo rosnących potrzeb inwestycyjnych w infrastrukturę społeczną, partnerstwo publiczno-prywatne (dalej: PPP) nie rozwija się zgodnie z oczekiwaniami w Polsce. Tylko 25% wszczętych postępowań kończy się na realizacji umowy – znacznie niższa stawka w porównaniu do innych krajów europejskich.*

*Chociaż istnieje wiele potencjalnych czynników słabego rozwoju PPP w Polsce, w tym artykule pokazano nieefektywności w modelu finansowania projektu, a także przeanalizowano możliwość zastosowania forfeitingu przez zrzeczenie w Polsce. Artykuł określa niezbędne warunki, a także potencjalne korzyści dla rozwoju PPP jeśli model forfeitingu poprzez zrzeczenie zostanie zastosowany kompleksowo jako sposób finansowania polskich projektów PPP. Omówione zostaną krytyczne czynniki sukcesu w PPP, a także podział ryzyka projektu i czynniki wpływające na cenę projektu.*

**Słowa kluczowe:** partnerstwo publiczno-prywatne, project financing, forfeiting przez zrzeczenie, bariery PPP w Polsce, zamówienia publiczne.

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## 1. Introduction

PPP is not developing in accordance with expectations in Poland – the rate of realized contracts is still very low, only at approximately 25% of initiated proceedings (Ministry of Development Funds and Regional Policy [MFiPR], 2020). The average project size and frequency of public-private partnership projects are also significantly below the European average. Taking into account the large potential for improvement, it is the aim of this article to showcase the forfeiting by waiver mechanism, as well as its potential for the advancement of the Polish PPP market.

The low rate of PPP implementation in Poland is not the result of lacking necessity – according to the Ministry of Development Funds and Regional Policy (MFiPR) (2017), an estimated PLN 1.5 trillion of capital investment is needed in Poland by 2030 for the maintenance of the current pace of infrastructure development. The Polish national budget does not permit such expenditures to be realized through project self-realization. Not meeting said investment needs, however, may significantly hamper Poland's economic growth as they concern key sectors of transportation and infrastructure. "In the railway sector, the reconstruction of 8,500 km of railway lines is planned (...), as well as the construction of 0.5 million housing units (...) in order to address the existing deficit in the housing sector. Significant modernization of inland waterways is also envisaged, costing between PLN 24.6 billion PLN and PLN 90.6 billion. In addition, more than PLN 200 billion is needed to implement the National Road Construction Program over the period 2014–2023" (Ministry of Development Funds and Regional Policy [MFiPR], 2017).

The 1.5 trillion PLN of capital investment also includes key areas of social infrastructure in the healthcare and education sectors, such as schools, universities and hospitals. Here a lack of investment may cause additional harm to Poland's development due to growing inequalities (Tusińska, 2017), which (as measured via the Gini coefficient) are proven to correlate with crime and violence (Chloe, 2008; Kennedy, Kawachi, Prothrow-Stith, Lochner, & Gupta, 1998), as well as many other undesirable social outcomes. In summary, it is hence evident that the need

for investment in social infrastructure in Poland is extensive, and not possible to meet via the national budget.

While not meeting the above-mentioned investment needs may prove to drastically hamper the economic and social development of Poland, the main options available to meeting said needs are very few:

1. Full privatization of certain areas of social infrastructure,
2. Self-realization of infrastructure projects,
3. Public-private partnerships.

The first option – privatization – offers many upsides as it harnesses private sector efficiencies (Luqmani & Quraeshi, 2011). The involvement of public administration in any investment project is unfortunately known to drastically increase the project completion time and cost, which can be omitted with privatized projects. Privatization however poses one major downside: it significantly reduces accessibility of social infrastructure to low-income individuals, as privatizing a project usually correlates with applicable fees for usage (an example thereof can be found with highway tolls or privatized healthcare systems). While from an economic standpoint, there is no fault in charging fees for usage of a service, ethical and social concerns do arise. The higher the percentage of a nation's social infrastructure is privatized, the higher the inequalities between the rich and the poor. As mentioned previously, inequalities strongly correlate with a nation's crime rate and occurrence of violence. It is hence not an economic but a political question of whether privatization of social infrastructure is desirable. Option two, project self-realization via taking out loans, is the one used in the vast majority of Polish infrastructure investments. Said option is however becoming increasingly difficult to access due to many municipalities reaching their debt ceiling. Over time, as outlined above, it will not be possible to meet the infrastructure needs due to budgetary constraints. This article hence showcases the applicability of option three – public-private partnership, which offers a good solution to highly indebted municipalities thanks to not being accounted for as public debt ever since the passing of the 2015 Act of Revitalization (Chancellery of the Sejm [Kancelaria Sejmu], 2015). Prior to the passing of the act, cities and municipalities had no

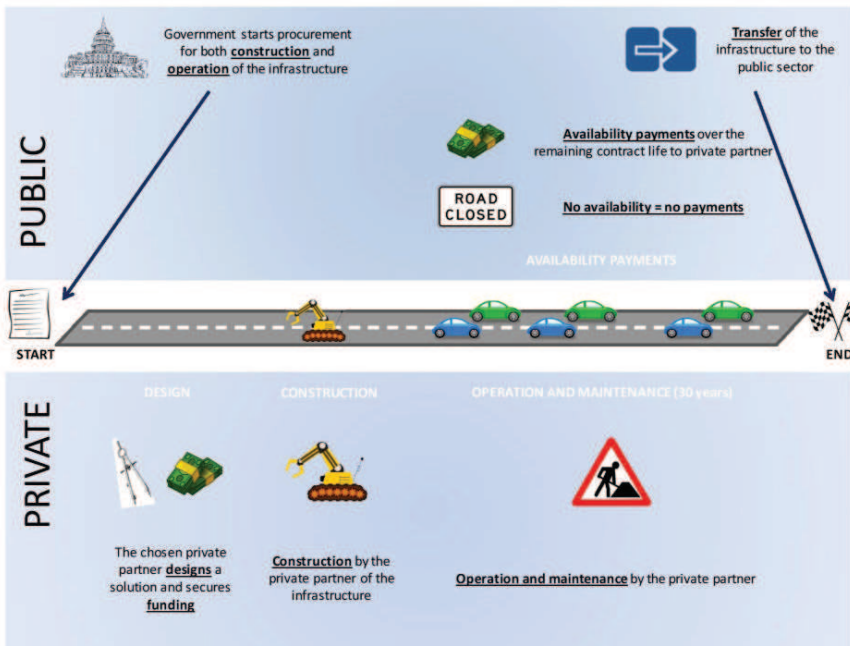
certainly as to whether or not PPP projects would be accounted for as part of public debt by financial institutions. This acted as a strong deterrent for the conclusion of PPP contracts – if a public entity found out post-factum that a PPP investment project was accounted for as debt, it may no longer would have been able to borrow necessary funds for the construction of other social infrastructure projects. The 2015 act however regulated said undertaking, clearly stating that a public-private partnership could not be accounted for as public debt. PPP therefore may pose the only viable alternative to privatization for indebted entities in need of social infrastructure investment. It also offers numerous upsides to privatization, the main one being the fact that the public entity retains full control over the accessibility of the newly created infrastructure, while also harnessing private-sector efficiencies.

## 2. DBFMO PPP projects

While there are various forms of PPPs, this article addresses the most common

form of PPP projects – the “Design-Build-Finance-Maintain-Operate” (DBFMO) contract (Dewulf, Blanken, & Bult-Spiering, 2012). In this type of PPP project, the private partner is responsible for all phases of the project – design, construction, operation and maintenance of the infrastructure for the entire project run-time (usually ranging between 10 and 20 years). The private entity is also responsible for the funding of the project, resulting in the creation of a project company (or special purpose vehicle), which takes out a loan in order to finance the construction of the infrastructure investment. Figure 1 showcases a representation of the different phases of a DBFMO PPP on the example of a road. The public entity starts the procurement process for construction and operation of a new road for a clearly defined project run-time. It then selects a private partner who is responsible for securing the funding (in the form of a loan), as well as the entire design and construction process.

Figure 1. Scheme of a typical Design-Build-Finance-Maintain-Operate (DBFMO) availability based PPP project



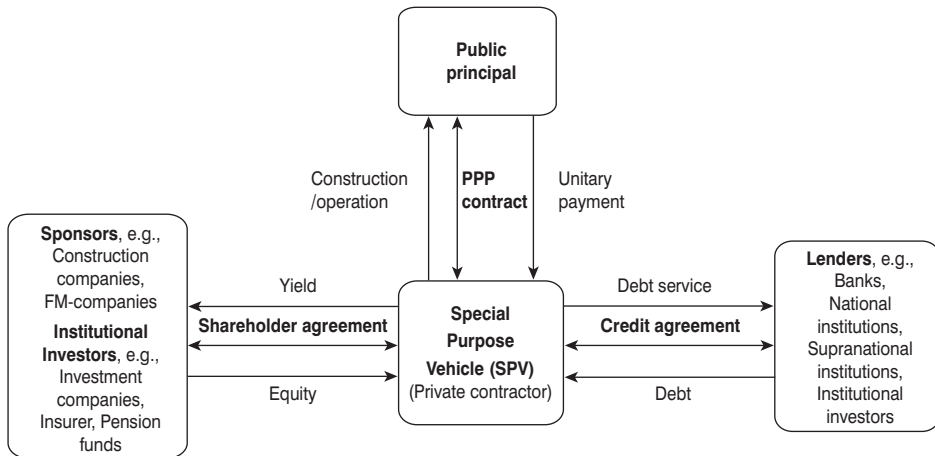
Source: European Court of Auditors (2018), p. 13.

After the road is constructed and available, the public party may then make use of it (by letting their citizens use said road). As soon as the road is ready for use, the private entity has the right to collect an availability fee from the public entity – comparable to the rent model. Said availability fee is collected for the entire project run-time. During the project run-time, the private entity is also responsible for the maintenance of the road, thereby taking over the responsibility for any repairs or damages – the degree and specificities of which are outlined in the PPP contract. At the end of the project run-time, the infrastructure project is handed over to the public entity. The private entity no longer collects availability payments, while also no longer being responsible for maintaining the road.

### 3. Project Financing

The primary method of financing which is currently used for PPPs in Poland is project financing. A basic model of project financing in PPPs is illustrated in Figure 2. This method is characterized by the private entity taking out a loan in order to finance the new infrastructure investment. The private entity then has the right to collect an availability fee from the public entity. Said availability fee is usually collected on a monthly basis for the entire project run-time and is used to cover the costs of the loan and project construction, as well as the maintenance of the road until the end of the contractual agreement.

Figure 2. A structural model of project financing



Source: Alfen, Daube and Vollrath (2008), p. 380.

This financing model places a lot of risk on the private entity, as well as the financial institution responsible for providing the loan. In the case of the private entity going bankrupt, the financial institution has no right to collect the availability fee directly from the public entity. Said risk is calculated into the pricing of the loan, making the entire project significantly more expensive.

Project financing also acts as a strong deterrent for private institutions to pursue PPPs, as much of the risk is placed onto them in said model. In the case of the public entity seizing the availability pay-

ments, the private entity has the continued responsibility to pay back the loan it took out for the infrastructure investment. Said deterrent thereby also likely leads to fewer private entities competing in the PPP procurement process, acting as another mechanism driving up the cost of public-private partnerships.

It is hence fair to assume that project financing does not offer an optimal financing solution for public-private partnerships in all cases due to said model making projects more expensive and less desirable to private entities (Alfen, Daube, & Vollrath, 2008).

## 4. Forfaiting

The concept of forfaiting is most prevalent in international trade and constitutes a widely used economic instrument, whereby an exporter surrenders their rights to receive payment for the goods or services delivered to an importer, in exchange for an instant cash payment from a forfaiting bank. The bank proceeds by taking over the exporter's debt instruments, hence assuming the full risk of payment by the importer. Forfaiting transactions are generally concluded on the basis of contractual agreements stating that the supplier of goods (the exporter) grants to the buyer (the importer) credit terms of payment (Bishop, 2004). Forfaiting transactions are in most cases documented in the form of bills of exchange and book receivables. Said forfaiting mechanism provides benefits to all parties involved: to the exporter, it offers an easy way of turning a credit sale into cash sale, while also eliminating political and credit risks. The importer, on the other hand, gains the flexibility to pay for their goods on deferred terms of credit with fixed interest rates.

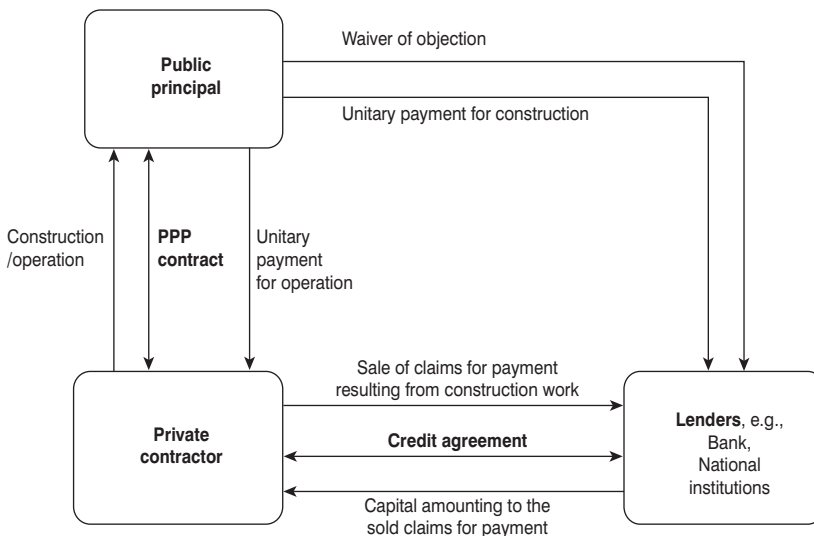
### 4.1. Forfaiting by Waiver

Forfaiting by waiver presents a model for financing which is primarily used for public-private partnerships in Germany

and to a lesser degree in France (Krumm, 2016). While forfaiting by waiver showcases major differences when compared to the classic forfaiting mechanism, its main upside prevails – namely that of risk transfer. According to the World Bank Group (2020), “[u]nder this model, once construction is completed satisfactorily, the government issues an irrevocable commitment to pay the project company a portion of the contract costs – typically sufficient to cover debt service. This can lower the project's financing costs. However, it means the government retains more risk under the PPPs. (...) Besides, the fact that payment is not conditional reduces revenue risk. It should therefore be reflected in the pricing of SPV debt. The forfaiting model has been widely used in Germany for small projects – typically municipal [ones] (...)”.

The basic structure of the forfaiting by waiver model is showcased in Figure 3. For this purpose, a project company (or SPV) is founded, which possesses the right to collect the availability fee from the public sector. The project company sells said right (referred to as “claims”) to a bank as part of a forfaiting contract. The bank, by force of said contract, acquires these claims from the project company as regulated under private law. At the same time, the public debtor expressly waives any objection.

Figure 3. A structural model of forfaiting by waiver



Source: Alfen, Daube and Vollrath (2008), p. 381.

## 4.2. Waiver of Objection

The decisive factor in the forfeiting model is the waiver of objection. Said waiver is particularly important as to mitigate the risk of poor performance, right to contest, retention and other rights to refuse performance by the public third-party debtor. This waiver of objection ensures that the bank remains unaffected by service disruptions within the contractual relationship between the public entity and the project company. It must also be ensured that forfeiting takes place at least in the amount of the credited service. The bank then, by force of the contractual agreement, is positioned as if it had concluded the loan agreement with the public entity itself.

Because the loan service is not in any way affected by performance disruptions within the contractual relationship between the public entity and the SPV, said model is considered to constitute an expressed guarantee of a liability declaration according to German law (Bundesgesetzblatt [BGBl], 2006). Forfeiting with waiver of an objection hence translates to forms of PPP financing in which a project company transfers all (or part of) its claims from a PPP contract to the financing banks. As a result, from the point of view of the credit institution, this model is the equivalent of a loan signed with a public entity. The essence of forfeiting with no objection consists in exchanging part of the project risks for the lower credit risk of the public sector. There is therefore no economic risk transfer from the public to the private sector. Usually only a part of the receivables is waived, which is required to cover the debt service. In the case of early termination of the contract, the claim of the project company for the settlement of damage against the public entity is also assigned to the bank. For the case of such a situation, the public entity also waives the objections to which it is entitled.

## 5. Critical Success Factors in Public-Private Partnerships

In their research, Ng, Wong and Wong (2012) outlined four of the most critical success factors (hereinafter: CSFs) for public-private partnership projects, which are as follows:

1. Financial and commercial factors:
  - The existence of service need
  - A government guarantee
  - The existence of a strong team of consortium members
  - The profitability of project
  - The stability of the economic environment in the country
  - The ability of the project to attract foreign capital
2. Political and legal factors:
  - The stability of political environment in the country
  - The experience of government in PPP schemes
  - The transparency of procurement system
  - The existence of a mature legal framework and adequate regulatory framework
3. Technical factors:
  - The technical manageability of project size
  - The reliability and experience of private consortium
  - Possible innovative solutions
4. Social factors:
  - The public's acceptance of the project
  - The consistency of the project with environmental issues
  - The price of service

The degree to which the forfeiting by waiver model can be applied to PPPs in a given country is largely dependent upon the first two CSFs outlined by Ng et al. (2012). Particularly the stability of the economic environment in a country is of essence, as well as the existence of an adequate regulatory framework. Without said legal framework, the implementation of a forfeiting by waiver model poses significantly more potential problems as compared to project financing due to the higher degree of complexity of forfeiting. If those conditions are however met, forfeiting by waiver offers a viable alternative with many upsides to traditional PPP project financing.

## 6. Forfeiting by Waiver as a Factor Influencing the PPP Project Cost

The project financing model poses a higher risk for the credit institution, as special purpose vehicle companies are a significantly less stable and trustworthy partner when compared to public entities.

Said risk is calculated into the credit price and ultimately paid by the public entity. Due to posing a significantly lesser risk to the credit institution, forfeiting by waiver reduces the project cost, while also posing a stronger incentive to the private sector to conclude a PPP agreement. Said incentive may, over time, lead to more competition in the PPP procurement process. An increase in competition is known to lower the final price, as well as is likely to drive up the quality of the final infrastructure investment (Nisar, 2007). It can hence be assumed that the forfeiting model decreases cost, increases competition and thereby also increases quality of the final infrastructure project. It must however also be noted that it shifts part of the project risks onto the public entity.

## **7. The Applicability of Forfeiting by Waiver for the Realization of Public-Private Partnership Projects in Poland**

As previously noted, PPP is not developing in accordance with expectations in Poland. This poses a large problem considering the increasing level of national debt (Klukowski, 2019) combined with a growing need for social infrastructure investments. Forfeiting by waiver could hence offer a viable solution for the development of a better functioning PPP market in Poland. Using said model as opposed to project financing could drastically reduce the project costs as well as incentivize a larger number of private entities to pursue PPPs. A larger number of private entities competing in the PPP procurement process could in turn additionally drive down the final project cost, while also increasing the quality of the realized infrastructure project.

The regulatory framework in Poland offers good ground for the forfeiting model being used in PPPs. The 2015 Act of Revitalization ensures that public-private partnerships are not accounted for as public debt, constituting an additional incentive mechanism for the public entities involved. This leads to the question of why said model is not used in Poland in order to incentivize the development of PPPs. There are many possible reasons for said trend. While the avoidance of higher risk in the forfeiting model certainly is one of the ele-

ments involved in forfeiting being unpopular, another reason could simply be found in the lack of knowledge and experience in the field of PPP. The PPP procurement process is quite complicated as is – municipalities with no prior PPP experience are likely unaware or do not possess the necessary legal support and know-how for the successful implementation of the cheaper forfeiting model.

Between 2009 and Q1 of 2020, less than half of public entities used consultancy services during the PPP procurement process (Ministry of Development Funds and Regional Policy [MFIPR], 2020), which is likely the result of the high costs associated with hiring lawyers. Without proper guidance, however, the vast majority of municipalities will not be implementing more complex financing methods.

In particular smaller municipalities with no prior PPP experience could drastically benefit from more comprehensive governmental guidance – e.g. in the form of legal and financial advisors being offered free of charge. Taking into account the growing infrastructure investment needs, it is hence of essence for the Polish government to create more comprehensive guidelines and PPP support entities in order to avoid socioeconomic stagnation or privatization of social infrastructure services. Forfeiting by waiver thereby offers a viable alternative to project financing and could aid in the development of a stronger PPP market in Poland.

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