PILOT LOCAL GOVERNMENT PARTNERSHIP PROGRAM

SUMMARY OF ACHIEVEMENTS IN INFRASTRUCTURE FINANCING AND DEVELOPMENT

Prepared for
East European Regional Housing Sector Assistance Project
Project 180-0034
U.S. Agency for International Development, ENI/EEUD/UDH
Contract No. EPE-C-00-95-001100-00, RFS No. 631

Prepared by
Chris Kaczmarski
Research Triangle Institute
under subcontract to
The Urban Institute

THE URBAN INSTITUTE
2100 M Street, NW
Washington, DC 20037
(202) 833-7200
www.urban.org

October 1997
UI Project 06610-631
SECTION I - BACKGROUND

With the ongoing political and economical decentralization process in Poland and with increased citizens involvement in local government decision making process, the public requests for provision of services and investment projects to improve the overall standard of living, receive more attention at the local level. One of the most challenging questions faced today by the local government officials is how to maximize the volume of capital improvement projects for direct benefit of citizens and for stimulating of economic development of the municipality given the limited budget resources available. There is almost no municipality that would not be currently involved in an active phase of infrastructure project planning or implementation. At the same time, these capital improvement projects can create serious impacts on a municipality's overall financial standing and require searching for new or alternative methods of project financing.

Gminas are increasingly aware of the benefits of using long-term debt finance to increase immediate levels of investment, complete projects quickly and start to gain benefits from these projects as soon as possible; both to stimulate economic growth and meet basic service backlogs. However, gminas currently do not have the capability to competently prepare medium-term projections of their financial conditions and debt-carrying capacity or prioritize and program investments projects within their realistic financial limitations. These are all necessary skills for gminas which will use long-term debt finance. Once the gmina has made the decision to debt finance well prepared projects, support is then needed to help make the decision regarding the most appropriate form of financing (credits, bonds) and to actually do the financing.

The ultimate goal of the Pilot LGPP with regards to provision of technical assistance offered under the Infrastructure Financing and Development Module was for the municipality to become proficient in long term planning of budgets and scheduling of capital projects accompanied by prudent use of long term funds presently available on Polish capital markets for municipal infrastructure projects financing. The work under this module was also expected to create the links for technical assistance delivery through other modules, e.g., Strategic Management, Budgeting and Finance as well as Strengthen Municipal Services and Enterprises in particular.

The complimentary services and training to partner gminas with the use of tools available under this module included the following:

- **Gmina Financial Analysis Model (GFAM) application** -with initial emphasis on defining debt carrying capacity and on infrastructure programming
- **Infrastructure Project Appraisal** -to provide the gmina a realistic independent opinion of the feasibility/desirability of proposed projects and to suggest the necessary revisions to make the project “bankable”
- **Infrastructure Long-term Debt Financing** (by municipality and/or by enterprises)
— *Long-term Loans* (Standardized Loan Applications/Marketing to Banks/Bidding Procedures/Evaluation/Negotiation)

— *Municipal Bonds* (Prospectus / Information Memorandum / Bidding Procedures/Evaluation/Negotiation)

• *Infrastructure Project Management* - to assist the municipalities that are at various stages of infrastructure project planning and implementation to set up proper procedures for avoiding potential problems and for maximizing the technical and financial control of the project throughout all phases of its planning and implementation and for resolving ongoing problems with infrastructure project management.

• *Capital Investment Planning* - through linkage to the Strategic Management, Budget and Finance Module

**SECTION II - TECHNICAL ASSISTANCE OVERVIEW**

Under the Pilot LGPP six out of eight partner municipalities received technical assistance in the infrastructure finance area. Those municipalities included: Kutno, Ostrów Wielkopolski, Bielsko Biala, Szczecin, Gliwice and Ziebice.

Some of the most important benefits arising from technical assistance and application of tools available under Infrastructure Financing and Development Module included the following:

• Stimulation of most effective use of gmina financial resources

• Promotion of transparency through provision of effective tool (GFAM) for internal and external communication, e.g. for Executive Board to communicate with Gmina Council, with Department Managers and with citizens and for Gmina to communicate with potential investors and with financing institutions.

• Optimization of Strategic Planning through implementation of medium to long term budget and investment program planning procedure.

• Establishment of financial framework for all forms of Gmina operations

• Introduction of debt management system

• Improvement in efficiency of multi-year project management

• Facilitation of analysis of economic development's impact on Gmina budget

• Stimulation of municipal enterprises restructuring process.
Tools

The complimentary assistance provided to the pilot municipalities relied heavily on the infrastructure finance tools. The following information provides the description of tools along with approaches taken in their implementation.

Gmina Financial Analysis Model (GFAM)

The initial purpose of the GFAM - is to assess the debt-carrying capacity of a municipality in relation to the gmina’s medium-term capital investment program which typically includes specific priority investment projects for immediate financing. The GFAM provides the capability to determine medium-term projections of revenues, recurrent expenditures and the resulting expected surplus available for investment and/or debt service. The GFAM then helps the city prepare a “mini-capital improvement program” of priority investments that fits within the realistic financial limitations of the gmina, using long-term debt financing as appropriate. Application of the model provides the initial immediate results of:

- Defining the debt-carrying capacity of the city and its realistic limitations so the gmina executive and council can decide whether or not to use debt-finance.

- Defining a preliminary “mini-capital improvement plan”, which forces the gmina management to adopt a medium-term perspective to investment priorities

- Providing a competent analysis which can be used for demonstrating credit-worthiness to commercial bank lenders and/or municipal bond investors.

These immediate results can equally be utilized in relation to commercial financing as well as any other type of subsidized financing available in Poland, such as loans from National and Voivodship Funds of Environmental Protection.

In six successful applications in pilot gminas ranging in size from 10,000 to over 400,000 population, the implications of the GFAM application typically reach far beyond the determination of municipalities debt carrying capacity to finance a specific infrastructure.
project. It leads to the natural and more far reaching secondary impacts of encouraging the gmina to:

- Use GFAM as a diagnostic tool in identifying key sectors where risks and opportunities for operational and performance improvement may be most productive to gmina management. Although by itself the GFAM and its basic application does not provide immediate answers to these questions the skillful site specific modification by experienced consultants will result in conclusions and recommendations supporting the above objective.

- Build upon the “mini-CIP” to create a full scale multi-year capital improvement program, or at least adopt the GFAM in the interim to continue to do the less sophisticated “mini-CIP” on a regular basis. The distinction between “mini-CIP” and the full scale CIP is that the “mini-CIP” is done based on existing information available at a gmina while the full CIP is to improve the information quality with respect to planning, technical and cost justification, and scheduling of investment projects throughout the process and package it properly for city staff, political leadership and citizens.

- Recognize the realistic financial constraints within which Economic Development Plans, Housing Strategies, etc can be developed.

**Infrastructure Project Appraisal Methodology and Criteria**

The Pilot LGPP provides assistance to gminas through appraisal of investment projects which have been prepared by the gmina for financing. This appraisal provides the gmina a realistic independent opinion of the feasibility/desirability of proposed projects and how potential lenders/investors will perceive the project. Advice is provided on what improvements are required to individual projects to make them “bankable” and what improvements must be made in the overall project preparation process of the gmina. It is therefore important to understand that actual preparation of project development documentation such as prefeasibility and feasibility studies, preliminary designs, etc. is not within the scope of offered technical assistance.

More specifically the following determinations will be made based on the application of specific Project Appraisal Criteria:

- Are the main objectives of the investment project clearly set and are the benefits associated with project’s implementation well defined.

- How advanced is the level of project development and is it sufficient for initiating the process of project financing.

- What is the status of project conformance with necessary permitting and regulatory requirements.

- Is implementation of the project in a proposed form going to satisfy the actual and anticipated needs and expectations of the municipality.


- How sensitive is the project to the possible changes requiring revisions in schedules, phasing, technology, size, etc., and resulting from differed social and economic requirements of the society.

- Is the municipality aware of and what are the impacts of the operating costs/ revenues associated with proposed project implementation on municipal budget and/or the users.

**Standardized Credit Application**

This tool provides gminas a Standardized Loan Application that can be used by gminas to apply for competitive bids from a number of commercial banks. The Standardized Loan Application, combined with the GFAM, provides all of the information that should be required by potential commercial bank lenders in order to make the decision to approve a credit. This tool has also been successfully pilot tested and is accepted by numerous commercial banks which have already been trained in evaluation of gmina credit-worthiness.

Once the Gmina’s debt carrying capacity is evaluated, the long term financing plan developed and specific project for financing appraised, a gmina can use the Standard Loan Application format to prepare a complete credit application package to seek the most competitive sources of funds available on the market.

**Model Prospectus and Model Information Memorandum**

For gminas which have performed the GFAM and wish to issue bonds to finance their infrastructure investments, both a Model Prospectus and Model Information Memorandum (as well as supporting commentary and user manual) have been developed. For very large issues (> 100 million PLN) which will be introduced into initial Public Trading on the Warsaw Stock Exchange (WSE), the Model Prospectus provides guidance on how to prepare the required prospectus. For medium-small issues which will be privately placed and subsequently traded on the regulated secondary Over-the-Counter (OTC) market, the Model Information Memorandum provides guidance.

Similar to the development of credit application package after the implementation of GFAM and based on the project appraisal, gminas can use the Model Prospectus and Information Memorandum to prepare for the issue of municipal bonds.
Infrastructure Project Management Manual

This manual will provide guidance to municipalities for all phases of infrastructure project planning and implementation. It will define all steps required from project conception to execution with detailed guidance regarding appropriate contents of pre-feasibility study, feasibility study, preliminary design, detailed design, contract document, bidding procedures, financing procedures, etc. according to Polish best practices, laws and regulations. The purpose of this tool is to assist the municipalities that are at various stages of infrastructure project planning and implementation to set up proper procedures for avoiding potential problems and for maximizing the technical and financial control of the project throughout all phases of its planning and implementation as well as for resolving ongoing problems with infrastructure project management.

This tool should be of special importance to those municipalities that will receive assistance in securing the long term commercial financing, upon the understanding that the benefit of obtaining the most competitive rates and terms of the funds may be minimized or eliminated unless the use of these funds during the project implementation proceeds in accordance with the most effective project management procedures.

SECTION III - IMPLEMENTATION RECOMMENDATIONS

Based on the experience gained in pilot municipalities to-date, the following is the normal progression of activities to be implemented in each gmina requesting assistance:

• Gmina request for assistance in long-term debt financing (credit or bond) of a specific infrastructure project

• Initial visit to gmina for:
  — Preliminary discussion of specific investment projects to be financed
  — Preliminary discussion of financing required, possible sources, budgets
  — Preliminary review of gmina's project management process and capabilities
  — Introduce GFAM and data collection requirements for gmina
  — Presentation to Executive Board & City Council on benefits of long-term debt financing and introduction of process
• Implement GFAM and Investment Project Appraisal:
  — On-site work with city staff for compilation of historic budget data, revenue/recurrent revenue projections and initial review/compilation of infrastructure project plans (normally non-existent). Concurrently, perform technical appraisal of investment projects.
  — Off-site work to input data into GFAM and produce preliminary results
  — Present preliminary results to Executive Board, work with gmina to prioritize investment projects and adopt long-term financing strategy based on budgetary surplus available. Presentation to Executive Board & City Council

• City Council approval for long-term financing of specific project, using credit or bond

• If commercial credit financing will be used:
  — Introduce Standardized Loan Application. City to complete using GFAM as basic data source. Quality control assistance provided, as required.
  — Advise gmina on bidding procedures to be established, help identify short-list of commercial banks with active municipal lending programs. Assist in marketing to banks.
  — Advise gmina on bid evaluation (using TIC model).
  — Advise during negotiations and contracting of loans.

• If municipal bond will be used:
  — Advise on type of bond/placement which is most practical
  — Advise gmina on preparation of Prospectus or Information Memorandum
  — Advise gmina on establishing underwriter bidding procedure
  — Advise gmina on bid evaluation (using TIC model), negotiations and contracting
  — Advise gmina on procedures for public trading of bond, if appropriate.

• Throughout the above process, critical deficiencies (both in the specific investment project to be financed and in the general project management system of the gmina) need to be identified. The Project Management Manual may be introduced and selective corrective actions may be recommended to the gmina.
Follow-up technical assistance and training should be provided to those gminas wishing to adopt the GFAM as a standard tool for medium-term planning and/or to gradually evolve from the mini-CIP under GFAM to full scale implementation of a comprehensive CIP.

PILOT LGPP CASE STUDIES

Kutno

<table>
<thead>
<tr>
<th>Population (1996)</th>
<th>51,053</th>
</tr>
</thead>
<tbody>
<tr>
<td>Location</td>
<td>Plock Voivodship</td>
</tr>
<tr>
<td>Budget (1996)</td>
<td>31,133,930 PLN</td>
</tr>
<tr>
<td>Investments as Percent of Budget (1996)</td>
<td>21.65%</td>
</tr>
<tr>
<td>Debt Service Factor (1996)</td>
<td>8.91%</td>
</tr>
</tbody>
</table>

In Kutno, the tools to analyze the credit worthiness of the gmina were developed as the model ones. The primary objective was to analyze municipalities capacity to undertake long term commercial financing for a project involving Final Construction Stage of the Wastewater Treatment Facility.

The most important conclusion from the financial analysis for 1995 - 2005 was to confirm that it would be justified to conclude a loan of a minimum 10-year maturity, which would allow Kutno to maintain a safe loan servicing to revenue ratio. Kutno was the first city to obtain a multi-year commercial loan, based on the tools developed under the USAID Program.

The GFAM Model has been used in Kutno to optimize the capital investment plan, and help program and prioritize projects and options for funding them such that financial liquidity is secured, and the ability to generate resources to accomplish “deferrable investment projects” is created. Due to the implementation of the Model, it was possible for the City to develop the “Program for the Operation of the Local Government of Kutno in 1995-2005.”

The staff of the City Hall has the skills necessary to use the Model, which makes it possible to use various simulations in order to prepare successive versions of the annual financial plans. At the same time, the President of Kutno is indicating the necessary update of the assumptions behind the Model because of the changing legal regulations and the economic condition of the City. Mr. Krzysztof Debich, the President of Kutno, says the following in his letter: “The Model is being used and updated on the current basis by the Finance and Economic Development Departments personnel.”

Ostrów Wielkopolski

<table>
<thead>
<tr>
<th>Population (1996)</th>
<th>75,000</th>
</tr>
</thead>
</table>
The financial analysis carried out in Ostrów Wielkopolski was subjected to the municipal bond issue in the amount of PLN 7,500,000. Consultants have developed the Offering Memorandum with intention to admit the issued bonds for secondary public trading on the OTC market. The proceeds of the issue were to finance a series of road projects in the City. This was the first municipal bond issue in Poland admitted to the OTC market. The Ostrów Information Memorandum was prepared in close cooperation with the Polish Security and Exchange Commission and was since transformed into a model document for other Polish municipalities wishing to enter the OTC market for secondary trading of municipal bond.

Due to the financial analysis in Ostrów Wielkopolski an appropriate safety margin for debt servicing was defined till year 1999 (the planned repayment of the first bond issue). The application of GFAM has also become a factor stimulating an annual development of long-term budget plans as well as a preparation of a “full scale” four-year Capital Investment Program (CIP).

Using the GFAM, a new municipal bond issue is planned at the moment. The bond is also in the amount of PLN 7.5 million, and of 7-year maturity (the longest in Poland so far).

The City of Ostrów Wielkopolski has regarded the GFAM as a “very useful and relatively easy to use tool, which enables simulations of different plans.” In addition, the financial analyses report for Ostrów Wielkopolski has become a standard form of a document submitted by the City Board to the Regional Audit Office supporting the City’s request for positive opinion on municipal bond issue.

Bielsko-Biała represents a case study example where timely application of the GFAM has prevented the city from making irrevocable errors in financial planning and serious short to long-term implications on the city’s ability to fulfill its statutory obligations towards its citizens.
The first introduction of the Model took place in the moment when the City was just a step ahead of finalizing a decision to stimulate new housing development by injecting PLN 100 million generated through a municipal bond issue planned for the year 1997. The results of the use of the Model and the completion of the financial analysis, have indicated that the credit capacity of the City was far too inadequate to contract a liability on such a scale. A bond issue to that amount would have caused a financial collapse of the City over the period of the two years that followed, and besides, it would have hampered investment activity in other, “non-housing” municipal service areas. It also turned out that the capital program of the City to be financed, was insufficiently developed and that it required refinement and precise definition of detailed tasks, costs and implementation schedules. By taking the above findings into account, the City decided to withdraw from its earlier decision to issue bonds in the amount of PLN 100 million.

The use of the GFAM Model has revealed that the maximum possible level of debt will be up to approximately PLN 30 million in 1997 and approximately PLN 70 million within the period of upcoming four years. At the same time, maximum annual ceilings for capital spending in individual budgetary categories were determined. It will be possible to maximize capital investment in the City in 1997 - 2000, mainly through long-term financing with bank loans of a minimum of 10 years maturity.

As a result of the analysis made in the Gmina, a financial framework for safe programming of capital projects and monitoring of the financial condition of the City, while servicing debt and implementing budgets, was determined.

Subsequently, the GFAM-based financial analysis report, together with a standard loan application, has resulted in an exceptionally attractive offer to the City by a number of commercial banks for an open line of credit, with a 10-year maturity and no commitment fees. This is the first case in Poland that a financial instrument of this kind is offered to a municipality. It provides for a smooth adjustment of the cash flow to the construction progress and associated expenditures. An option is being considered to refinance the resources used through the credit line with a bond issue, once the outstanding debt under the credit line reach appropriate levels to make the bond issue feasible and financially effective.

Ziębice

<table>
<thead>
<tr>
<th>Population (1996)</th>
<th>19,980</th>
</tr>
</thead>
<tbody>
<tr>
<td>Location</td>
<td>Walbrzych Voivodship</td>
</tr>
<tr>
<td>Budget (1996)</td>
<td>13,537,733 PLN</td>
</tr>
<tr>
<td>Investments as Percent of Budget (1996)</td>
<td>24.63%</td>
</tr>
<tr>
<td>Debt Service Factor (1996)</td>
<td>3.25%</td>
</tr>
</tbody>
</table>

The financial analysis was carried out in Ziębice as one of those forms of technical assistance the City Board wanted the most under the Pilot Local Government Partnership Program available technical assistance choices. The Gmina of Ziębice is the smallest of those covered by infrastructure finance technical assistance. The financial analysis was completed in Ziębice by the consulting firm of DS Consultants under
close supervision and quality control of the Municipal Advisory Team. The staff of DS Consultants engaged in the assignment was previously trained in use of the infrastructure finance tools at the first Lublin School of Business workshop in November 1996. The analysis covers a period of 1994 through 2006. According to the City Board, the greatest benefit of the use of the Model will be to create a methodology and to obtain a transparent and efficient tool to launch a multi-year capital investment program, as well as multi-year budget plans.

Beside those benefits of a rather general nature, a direct and one of the most visible effects of the use of the Model in the Gmina of Ziêbice was to indicate, how long-term financing shorten the “rural water supply system” project implementation from 18 years to 6 years, while securing appropriate levels of investment in other sectors of municipal services. The results of the financial analysis and suggestions it had come up with were presented to the City Board and to the Councillors during a special session. The report from the financial analysis was additionally presented during a Pilot LGPP workshop to a larger group of staff.