

October 16, 2013

H.E. Edmond Haxhinasto
Minister of Public Works and Transport of Albania

Dear Minister Haxhinasto,

Following your request to prepare recommendations in relation to possible ways of implementing the Milot-Morine road concession project, IFC is pleased to share with you the following analysis.

Scenario Explanation

As per your suggestion we have prepared three scenarios under which the project could be implemented. The main differences between these scenarios are in the scope of capital works which would be performed by the concessionaire, which in turn influences the degree to which the Government of Albania would continue being involved in the road's construction and operation, the level of tolls which drivers would pay, and the amount of subsidies which the Government would pay to the concessionaire.

The first scenario presents our view of the best balance between maximizing private sector investments which are needed to preserve the road, keeping toll rates affordable, and minimizing budget commitments, which we understand to be the three most important Government priorities in relation to this project. This scenario contains fair risk allocation between the parties, safeguards the interests of the public sector and provides adequate returns to investors. In our opinion the project should be implemented under this scenario.

The second scenario minimizes the level of investment which is to be made by the private sector, resulting in the lowest toll rates to road users and minimizing the likelihood that the Government of Albania will have to pay subsidies to the concessionaire. On the other hand, this approach shifts fiscal responsibility for several important issues to the Government, most importantly part of geotechnical stabilization works and construction of a new Drini river crossing and Kukes bypass. As such, in our view this approach provides an incomplete project solution from the Government's point of view, leaving it exposed to substantial financial commitments and/or legal liabilities in the future. Nevertheless, we believe that this scenario can be feasible and can attract sufficient interest from operation and maintenance companies.

*F. Kitiro
per memo
the memo
draft.*

[Handwritten signature]

The final scenario maximizes the level of investment and responsibility which is to be assumed by the private sector. As such, it provides a comprehensive project solution from the Government’s point of view. However, it also results in prohibitively high toll rates and substantial subsidies which the Government must pay to the concessionaire from the budget. This scenario was proposed to investors by the previous Government but did not result in any bid submissions. We believe that this approach is not feasible.

Graphically, the three analyzed scenarios can be presented in the following way.

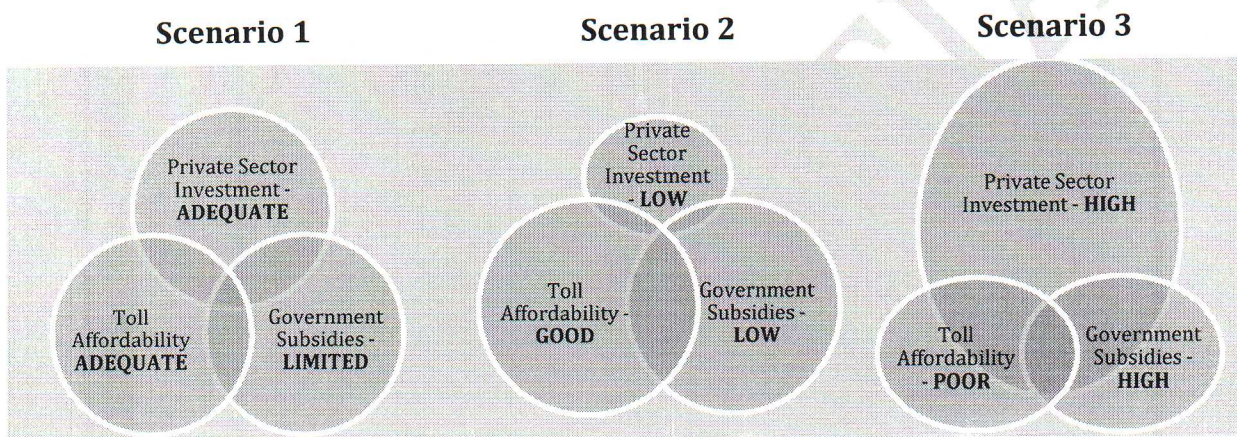


Table 1 – Project Scenarios

	Scenario 1 – Optimal Case	Scenario 2 – O&M Concession	Scenario 3 – Maximum Investment
Capital Investment	€34M-€37M	€22M-€24M	€100M-€105M
1. Dualization of Segment 1	Not part of the concession. Dualization to be funded by the Government (preferably this should happen when traffic reaches sufficient levels in 12 to 15 years,	Not part of the concession. Dualization to be funded by the Government (preferably this should happen when traffic reaches sufficient levels in 12 to 15 years,	Part of the concession. Dualization to be funded and carried out by the concessionaire within the first three years of the concession

	but can be sooner if the Government is prepared to pay)	but can be sooner if the Government is prepared to pay)	
2. Geotechnical Works	Most of the package of “initial stabilization measures” identified by IFC, worth approximately €10M	About half of the package of “initial stabilization measures” identified by IFC, worth approximately €7M	The entire package of “initial stabilization measures” identified by IFC, worth approximately €12M
3. Drini River & Kukes bypass	Concessionaire provides an ‘optimized’ solution (costing not more than €12M) within the first five years of the concession	Concessionaire does not provide a solution, responsibility stays with the Government	Concessionaire implements the existing bridge-tunnel solution within the first three years of the concession
4. Improvement of the Old Drini Bridge	Government to rehabilitate, operate and maintain at its own discretion (estimated investment is €650K)	Concessionaire will rehabilitate. Old bridge will be part of the concession	Concessionaire to rehabilitate, Government to operate and maintain
5. Motorway Improvement Measures	Concessionaire to implement in full within the first few years	Concessionaire to implement in full within the first few years	Concessionaire to implement in full within the first few years
Traffic Risk			
1. Availability Payments	No	No	Yes. Annual payments from the budget
2. Minimum Traffic Guarantee	Yes. Government payments possible but exposure limited	Yes. Government payments unlikely, exposure very limited	No
3. Subsidies Payable by the Government	Maximum likely annual exposure of around €1M (if the traffic guarantee is activated and actual traffic is 10% below guaranteed traffic)	Maximum likely annual exposure of around €0.5M (if the traffic guarantee is activated and actual traffic is 10% below guaranteed traffic)	Obligatory annual subsidies of between €4.5M and €5.5M for 27 years
Toll Rates			
1. Expected level	Likely range of €5.3-	Likely range of €4.0-	Likely range of €8.0-

	€5.9 (740-825 Lek) per passenger car before VAT	€4.5 (560-630 Lek) per passenger car before VAT	€9.0 (1,120-1,260 Lek) per passenger car before VAT
2. Affordability for drivers	€4.6-€5.2 cents/km; well within regional range; about 10% lower than in Croatia and Bosnia and about 30% higher than in Macedonia and Serbia	€3.5-€3.9 cents/km; at the lower end of the regional range; about 40% lower than in Croatia and Bosnia and 10% higher than in Macedonia and Serbia	€7.0-€7.9 cents/km; would be the highest tolls in the Balkans; only slightly below Western Europe levels

Optimal Case Justification

Following is a more detailed explanation of considerations on the basis of which we have defined the Optimal Scenario.

Dualization of Segment 1

Due to its high cost (between €55M and €60M), dualization of Segment 1 of the highway by the concessionaire creates insurmountable financial problems for private investors. Our financial analysis shows that if dualization of Segment 1 is added to all other capital investments which the concessionaire must make (most of which are necessary because they enhance the level of service and improve driver safety), it would have to charge tolls of around €8.5 (or 1,200 Lek before VAT) per passenger vehicle AND receive annual subsidy from the Government of around €5M per year for the remainder of the concession period following completion of construction (i.e. for 27 years) in order to be able to pay back the debt and earn an acceptable rate of return on its investment.

We believe that this level of tolls would be very high and hence unaffordable for many drivers who currently use the road so its introduction would lead to a substantial decrease in traffic, requiring the Government to cover this additional shortfall in revenues on top of the €5M annual subsidy which it would already be paying. Moreover, we are convinced that with the exception of situations where drivers' safety is jeopardized, expansion of highway capacity should be tied to the level of service and that dualization of Segment 1 of the Milot-Morine road is absolutely not warranted from the economic point of view for the next 12-15 years. Absence of bids during the last tender process, which included dualization of Segment 1 in its scope, confirmed that putting responsibility for these works on the concessionaire without providing Government commitment to pay annual subsidies is not feasible. For these reasons we strongly recommend that dualization of Segment 1 does not become part of concessionaire's responsibilities and that instead it can be funded either by the Government or by the concessionaire when traffic reaches sufficient levels.

Geotechnical Works

According to our findings the risk of slope failures and landslides is quite significant along Segments 2 and 3 of the Milot-Morine highway. Such events can present significant danger to the lives of drivers and can substantially deteriorate the highway's condition. In our opinion, slope stabilization and geotechnical hazard reduction works must form an essential part of this project. Moreover, because the concessionaire will have substantial expertise in carrying out such works, and because it will be responsible for managing the highway's operation and maintenance, it is best that the concessionaire performs as much of these works as it can afford.

We propose separating geotechnical works in four categories: initial stabilization works, ongoing preventive works, emergency works, and rehabilitation works. Initial stabilization works are measures which have been identified by IFC's engineers following months of detailed analysis and which in our opinion must be carried out as soon as possible. The cost of these works has been estimated with a relatively high degree of precision at around €12M. Because the scope and cost of these works is well defined, we believe that the concessionaire can and should be responsible for carrying them out within the first few years of the concession period. At the same time, we also recognize that initial geotechnical stabilization works are only one part of concessionaire's total obligations, which according to our analysis should not significantly exceed €35M (otherwise tolls would be too high or the Government would have to pay subsidies). With this in mind, we propose limiting the cost of initial stabilization works to approximately €10M and making the concessionaire responsible for their implementation. This will achieve a good balance between having the concessionaire perform urgently needed geotechnical works while keeping tolls at reasonable levels.

Another type of geotechnical works whose cost can be estimated with a relatively high degree of certainty are emergency works, which are works needed to clean up loose material from the carriageway after a landslide. Our engineers estimate that cleanup of a major landslide should on average cost around €50,000 and that it is very unlikely that more than one major event of this nature can take place in a year. Therefore, we propose making the concessionaire responsible for emergency geotechnical works but limiting his exposure to €50,000 per year. This approach would incentivize the concessionaire to carry out proper geotechnical routine maintenance while allowing bidders to estimate the maximum cost of emergency geotechnical works for the purposes of preparing their financial bids.

Finally, because it is impossible to estimate with a high degree of precision the cost of ongoing preventive geotechnical works (preventive works which would still be needed after the concessionaire carries out initial stabilization works) and rehabilitation works (works which would be required to stabilize slopes following landslides), we believe that the Government of Albania should assume responsibility for these works. Otherwise, in

order to decrease their exposure, bidders will substantially inflate these costs for the purpose of preparing their bids, which will result in excessively costly bids.

We believe that the approach described above provides optimal balance between cost effectiveness and utilization of private sector expertise in relation to geotechnical works.

Drini River & Kukes bypass

The existing Drini bridge around Kukes provides a suboptimal solution in terms of the road's alignment and level of service. Moreover, because the bridge is rather old and its as-built drawings are not available in electronic format, it is difficult to estimate with a high degree of certainty whether it is in good enough condition to operate safely for the next 30 years. For these reasons, it appears reasonable that if it can be financially affordable, providing a new solution for the Drini river crossing and Kukes bypass should become concessionaire's responsibility.

At the same time, based on existing designs and cost estimates (around €35M for a bridge-tunnel solution), making this responsibility of the concessionaire would be unaffordable. IFC's engineers did their own estimation of construction costs and in their opinion the bridge-tunnel solution would cost around €24M. Our financial analysis shows that even this reduced cost of the bridge-tunnel solution would still be too high and would lead to excessively high tolls.

Therefore, we believe that a new Drini river crossing around Kukes can be made part of the concessionaire's responsibilities only if the current cost of this solution can be significantly reduced. Financial analysis suggests that the final cost should not exceed €10M-€12M. This would mean dropping the tunnel and instead optimizing the bridge solution, most likely through a change in the alignment. If it becomes obvious that such optimization and cost savings are not possible, we would recommend approaching this issue in the same way as dualization of Segment 1, i.e. excluding these works from the concession contract while leaving the possibility for the Government or the concessionaire to fund these works later.

In order to reach definitive agreement about how to proceed in regards to this subject, we propose carrying out additional discussions between IFC, ARA and the designers as well as seeking feedback from investors who are interested in bidding for the project.

Improvement of the Old Drini Bridge

If a new solution for the Drini river crossing and Kukes bypass can be financially affordable for the concessionaire, the existing Drini bridge should be excluded from the concession. Responsibility for its continuous operation and maintenance should be transferred to the Government (either local authorities or the ARA), who should also consider making some targeted investments in order to improve the bridge's condition. Our engineers estimated that the bridge requires approximately €650,000 worth of investment, following which it should be able to continue serving the Kukes community for some time.

On the other hand, if the new solution cannot be implemented by the concessionaire, then he would be responsible for upgrading the existing Drini bridge and for its subsequent operation and maintenance.

Motorway Improvement Measures

There are a number of investments which must be made in order to bring the highway closer to a proper 'motorway standard'. These include construction of several interchanges and at-grade intersections, provision of proper entrance and exit lanes, closing of unauthorized access points, provision of lighting and fencing, installation of signs and markings, installation of a toll plaza, and provision of a storm water runoff system. Our engineers have estimated that the cost of these measures should be in the range of €15M. Responsibility for funding and performing these works should rest with the concessionaire.

Traffic Risk, Budget Exposure and Tolls

Under the project implementation structure which we are proposing in the Optimal Case, the Government of Albania will be able to avoid obligatory annual payment commitments to the concessionaire (i.e. availability payments). We believe that a minimum traffic guarantee structure can be used instead. Under this structure, the Government would guarantee that the concessionaire would receive revenue which would be sufficient to operate and maintain the road, pay back the debt and recover its invested equity.

In years when actual traffic would be below the guaranteed amount, the Government would have to pay a subsidy to the concessionaire. However, our analysis suggests that even if the Government ends up paying under the minimum traffic guarantee, the extent of its financial exposure would be limited. For example, if toll rates are kept at an affordable level, i.e. around €5.5 per passenger car, traffic is forecasted to be around 5,000 AADT and the minimum traffic guarantee is set at 90% of this level, i.e. at 4,500 AADT, the risk that actual traffic would fall much below the 4,500 AADT mark is quite low. Nevertheless, if this were to happen, i.e. if for instance actual traffic fell to 4,000 AADT, the Government would have to pay €1,003,750 as a subsidy to the concessionaire for the whole year ($[4,500 \text{ AADT} - 4,000 \text{ AADT}] \times €5.5 \text{ toll} \times 365 \text{ days}$). This amount is relatively small when compared to the €4M per year which the Government would have to pay to properly operate and maintain the road without a PPP or to the €5M annual availability payment which it would have to pay under Scenario 3. Moreover, it is worth keeping in mind that the risk of actual traffic falling below the guaranteed amount would be highest during the first few years of the concession period and would fall with every passing year.

Finally, in addition to limited potential budget exposure, the Optimal Scenario also delivers affordable toll rates. Our financial analysis suggests that under the assumption that capital investment will not exceed the level of €34M-€37M, toll rates could be kept around the €5.5 (750 Lek) mark per passenger car before VAT. On a per kilometer basis this would be

below the rates which are currently used in Croatia and Bosnia and only about 30% higher than in Macedonia and Serbia, both of which have the lowest tolls in Europe.

We are ready to meet at your convenience in order to discuss these issues and agree about the next steps.

Sincerely,

Georgi Petrov
Regional Business Line Manager
PPP Transaction Advisory
Europe and Central Asia
International Finance Corporation

cc: Ms. Elira Sakiqi, Senior Country Officer, IFC