

# Implementation of the Concession Mechanism for Infrastructure Development

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*The development of infrastructure is one of the key indicators of the entity's economic development potential, whether the entity is corporation, industry, national or supranational economy. As the third world countries accelerate development, and as the basic infrastructure in developed countries gets older, the gap between existing and needed infrastructure will grow. Consequently, the necessity for the review of infrastructure development emerges, as well as the need to create new and renew old methods, models, approaches and techniques for the realization and financing of infrastructure projects. This paper presents the concession as a mechanism of public-private partnership for the management of systematic infrastructure development. Particular emphasis is put on the multidimensional role of the government and on potentials of infrastructure development to change its attributes from incremental and inert to radical and rapid.*

## 1. Introduction

The growth in infrastructure, according to the traditional understanding of the needs for infrastructure, should be at least equal to that of the gross domestic product of the national economy. Due to numerous factors, however, the modern trends change this paradigm. The needs for new infrastructure are under the impact of an accelerated depreciation of infrastructure facilities in the developed countries, as well as the increase in the number of population and the urbanization process in the countries of the so-called "third world". Additionally, creating the global supply chains and networks and other globalization effects only makes the needs for infrastructure more complex.

Regardless of the influence of individual factors, the private initiative in financing infrastructure projects gains in popularity due to its market characteristics, especially as regards efficiency and effectiveness. The traditional manner of financing in the infrastructure sector is rather unlikely to be entirely replaced by financing from private sources, however, it is to be expected that there will be at least some positive incremental changes in this field. The most popular and theoretically best founded approach in practice is obviously the one relying on the implementation of concession mechanisms and BOT arrangements in financing infrastructure needs.

## 2. Economic justification of investing into infrastructure

The level to which infrastructure is developed, however pretentious and ambiguous it may seem, is the most reliable indicator of an economy's development. Numerous authors used indicators such as elasticity of investments and implicit revenue rate to calculate the productivity of investing into infrastructure and their findings were surprising. The initial studies [2] on the productivity of the

American non-military infrastructure capital in the late eighties and the early nineties of the last century show that the returns rate of the investments into infrastructure amounted to around 60%. Further empirical studies [7] of transportation and telecommunication infrastructure in the developing countries show that the returns rate is slightly over 60%, whereas the return to investments into transport infrastructure in the OECD countries and the developing countries, according to [4], reached extreme values of 95%.

Contrary to the initial studies in the eighties and the early nineties, which overrate the consequences of investing into infrastructure upon the economic growth, more recent analyses show more modest estimates of the effects of this impact. The reason for this is the implementation of more substantial tools, a larger number of quality data, refined models and substantial methodological approaches. The direction and the intensity may not be as they seemed to have been in the previous years, however, a positive impact of infrastructure upon the development is evident. Hence a significant rise in private investments into infrastructure in the new millennium. The amount of investments in the first six years, according to the World Bank data, is doubled in comparison with the last decade of the twentieth century. Merna and Njiry [18] especially stress the perspectives and the importance of the investments into infrastructure in the developing countries, pointing that in absolute figures they amount to USD 200 billion annually, a relative 4% of the national output, that is, 40-60% of overall public investments.

An important conclusion of these studies is that the infrastructure projects financing differs from other public investments and expenditure to a considerable extent. As a rule, certain empirical studies show a negative correlation between public spending and the GDP growth and the productivity [16]. This is explained by the fact

that public spending has no impact upon the public sector efficiency, and is funded from distortive taxes that have a negative effect upon the scope of private investments, through the systems of reducing the total return on investments.

Public funds and the credit capacity of the countries are insufficient to satisfy a growing need for infrastructure [25], especially in case of the EU member countries and the candidates for accession into the Union that are under the additional pressure of the Maastricht Treaty. Accordingly, there is a need that the private initiative should be more fully involved in the financing and execution of infrastructure projects. A large number of both practitioners and academics maintain that it is only the partnership between the public and private sectors (PPP) that can be sustainable in the long run [20]. Private initiative is no novelty in the developed countries; in Great Britain it is used to a large extent [26].

The private share in the overall investments into infrastructure in the end of the last millennium varied from the low 9% and 13% in Germany and France, to the extremely high 47% and 71% in the U.S.A. and Great Britain, respectively [21]. The practical verification of the positive effects of the infrastructure systems privatization effect phenomenon resulted into a sort of overrating its importance for the economic efficiency, on the basis the social expenditure remains unchanged. It is not, however, likely that the private financial initiative will entirely replace the traditional way of financing infrastructure projects from public sources. It is more likely that it will more or less serve to diminish the gap between the needs for infrastructure and the potentials of individual national economies in meeting these needs.

Regardless of the above mentioned, the most important aspects and trends of the modern policy and strategy of infrastructure development are related to the privatization and private investment concepts. The commitment to the idea of state intervention and the resulting changes in the political attitude towards private capital as a useful ally in the infrastructure sector arose in the early 1980's, the trend expanding soon after and getting new shapes and forms.

In the execution of infrastructure projects the private initiative is most often present in the form of the basic mechanisms of public-private partnerships, namely, concessions and BOT arrangements, and the quality of these mechanisms can be improved by hybrid financing instruments and execution [22] [6]. The hybrid models actually allow for either the incremental multistage selection of private partners or joining a number of smaller jobs into a whole. The goals are most frequently to

achieve the economy of scope in a more adequate way, that is, to avoid rival relations and acrimony which sometimes characterises the conventional models of project execution. Instead, they ensure that all parties collaborate to the benefit of the infrastructural project.

### 3. Concessions and bot arrangements

The European Commission [8] differentiates between two forms of public-private partnership: contractual and institutional. In the former, by far more frequently present in practice, the collaboration between the public and the private sectors is characterised exclusively by the contract elements, hence these are most often concessions. The latter includes a joint establishment of a new legal entity for the purpose of infrastructure project execution. It is rather rare in practice, since its inherent characteristic is the potential to ensure a monopolized role to the private partner.

The concession includes various types of contracts by which the public authorities delegate the rights to the national or foreign economic entity to perform a certain activity under specific legal conditions. To be more concrete, according to the Concession Law (ZOK) of the Republic of Serbia of 2003 (whose introductory regulations are equal to those in the 1997 law), concession is defined as the right to exploit a natural resource or a public property, or the right to perform an activity of general concern, which the competent state body (conceder) transfers to a national or foreign entity (concession holder), under strictly stipulated conditions and for an appropriate compensation [27]. The demand for concession contracts is the result of insufficient accumulation in some national economies. Such economies are not in a position to autonomously initiate and determine the dynamics of their development. The shortage of state funds, however, is not the only reason for the implementation of the concessionary forms of investments.

The concession contract stipulates the transfer of a public property, right, activity or a facility for the purpose of satisfying the public concern, rather than create a business community. Contrary to the above mentioned, the BOT arrangement focuses upon the provision of financial means and determining the model of risk distribution. According to [14], a BOT project can be described as a "project based on approving of a concession by the concedent (usually a public or state agency) to a consortium or a concession holder (usually from the private sector) whose responsibility will be to "build" (which includes financing, design, project implementation management, etc.), "operate" (including the management and operating and doing business using the facilities and plants, maintenance, service provision, collecting payments in order to cover the financial and investment ex-

penses, etc.), and “transfer” the facility or plant in the operative state and without additional costs to the concedent at the end of the concession period.”

Generally, the BOT system means a specific form of concession by which the construction of a facility, a plant or a workshop is transferred, by means of project financing on the build – operate – transfer system. Here the contract includes the construction and financing of a complete facility, plant or workshop, its exploitation and its transfer into the ownership of the domicile public authorities in a contracted term whose upper limit is generally determined by law. On the expiry of the contracted period, the private sector entity transfers the facility to the body in charge or a new private entity selected by a public bid. The period of the concession or a BOT arrangement is in the function of the risk the private party takes. According to [8], the lower the risk taken and the lower the financial returns to the project, the shorter the concession period.

Basically, there are three parties in the implementation of concession and BOT arrangements: (1) investors, who provide financial means, build and operate the infrastructure facility; (2) the government of the host country who provide guarantees; and (3) the third party (commercial banks, multilateral exim banks, suppliers, etc.) [5].

#### **4. Conceder's role in concession contract implementation**

Through its institutions and organizations, the state plays the key role in the concession and public-private partnerships management and development, regardless of the level of the authority delegated to the private sector. The main reason, evidently, is a high socio-economic value of infrastructure projects. Poor project funding, management and development inevitably result into their failure. The concessions and BOT models require an active collaboration and support from the concedent, a stable political and economic climate, a defined and stable legal environment, a convertible currency, as well as other conditions the investors expect anyway.

The state and quasi-state bodies create the legislative and overall conceptual framework for the development of the concession as an element of the partnership between the public and the private sectors. Chronologically viewed, as a public-private partnership approach, the concession is not a static concept, but rather an evolving one. From the rudimentary partnership characterized by a high level of informality, the concessions and public-private partnerships have evolved into a contractual and institutionalized relationship between the public and the private sectors including a wide range of models [13]. Hence a further theo-

retical and practical establishment of the concession process and the development of specific models to execute infrastructure projects is anticipated.

Even though the intervention potentials and responsibilities in the execution of infrastructure projects are manifold and complex, it is of paramount importance that they should be systematized. In principle, the state has to:

- 1) Define and create a general environment for the development of public-private partnership,
- 2) Be actively involved in the selection of the private agent, and
- 3) Monitor the execution of infrastructure projects directly or indirectly.

#### **4.1. Creating an adequate investment and regulatory environment**

The investment environment can be defined as a system of macrosocial, political, legal and economic institutions that shape and define the limits of the behaviour of micro subjects in the social, political and economic exchanges, i.e., to whom an investor (either public or private) can apply to protect his rights [17]. According to [15], it is necessary that a well defined, however not too bureaucratic, legal and administrative business environment be created. The initiative and the willingness of the private sector to participate in the projects of public concern largely depends upon the complexity of the social, economic, legal, ecological, and other conditions. The aim of creating a favourable operative environment is in diminishing the risk which is impossible to control from the point of view of the project executors. In certain cases it is necessary that we should go further from the general socio-economic conditions, namely, create additional guarantees to the private sector, most often in the form of the minimum guaranteed price or tax reliefs for a certain period of time.

The willingness of the private sector to develop infrastructure projects also depends on the legal and regulatory framework in which the project is operationalized [14]. In accordance with the study [19], the most advanced and the richest economies tend to create similar institutional solutions that include a transparent legal system with the norms created in representative democratic institutions which are universally adopted and interpreted by an independent court and display an unbiased and efficient approach in applying public legal norms. The building of the institutions of the system, as much as a phrase it may seem, is not just a simple role, but a precondition for a public and private sectors to co-operate. This is especially evident in long-term and capital-intensive projects. The execution of infrastructure projects should not be a political idea of the current gov-

ernment structure; there must be a clear legal and administrative framework for the execution of projects in order that the risk be equally distributed and the chances be reduced for destructive and corruptive behaviour of the agents.

#### **4.2. Creating proper institutions for the concession holder selection**

The sensitivity of the role the state plays in creating public bodies to select the private partners is reflected in the need for a quality institutional framework for creating and conducting a tender, as well as defining the selection criteria and the methods of concession holder selection. The concession holder that distinguished himself in a cost or quality terms is acceptable, and in the optimum case he is favoured by each and every criteria compared to other concession holders taken into consideration.

On the basis of some empirical studies, Kumaraswamy and Zhang [14] have found that the tender costs in the BOT model are by far larger compared to the traditional projects. Namely, in the BOT models, the costs amount to 0.48-0.62% of the value of the entire project, whereas in the traditional models this value ranges between 0.18 and 0.32%. Accordingly, the tender procedure for the BOT models requires that the protocols be established to select the contractor who will in turn ensure an optimal efficiency of the project.

The authorised bodies in charge of conducting the tender procedure must be autonomous in their work. In absolute values, this autonomy has to do with the relationships with all the prospective participants in the tender process, however the debate is still open as to whether this autonomy is necessary as regards the political power in the country. The majority of the countries, however, have adopted the model in which the regulatory bodies are highly autonomous as regards the political establishment.

The more concrete measures that ensure the autonomy of regulatory bodies refer to an a priori defined term of mandate of the members that is generally longer than that of the political structures; to a detailed definition of the processes in the working bodies and the terms of appointment of the members of the body; to restrictive regulations that define the circumstances in which the members of regulatory bodies can be suspended; as well as to a clear system of financing. Kerf et al. [11] further claim that it is important to establish a regulatory body financing mechanism.

Generally, the regulatory framework in the European countries, according to [8], defines three key procedures in a tender type selection:

- The open procedure, where any interested party may take part in the tender procedure,
- The restricted procedure, where any interested party may take part in the pre-tender qualifications. If the party qualifies, they can submit their tender,
- The negotiation tender procedure, similar to the restricted procedure, but allowing for an opportunity of post-tender negotiations on contractual specifications.

The completion of the plans and the selection of the optimum project solution are normally followed by the projects going public and the invitation to the parties interested in providing the works to take part in the tender. In accordance with the EU legislation, a Request for Proposals is sent, containing all types of contracts and the criteria to be used in the selection of the winner in a tender. Actually, a method of concession holder selection is defined, and the criteria in these selection methods are rather diversified. In extreme cases, the criteria are the price on one hand, and the quality of the service on the other, however, the combination of these two criteria seems to be most common.

The tender committee, convened by the employer, decides upon the optimum offer according to all preferred criteria. When the criterion is only the price, the procedure of the concession holder selection is simple and includes only the acceptance of the offer quoting the lowest price. More innovative methods in concession holder selection, however, also include the quality based criteria.

#### **4.3. Active participation of public bodies in the project life cycle phases**

Contrary to the previous roles, whose importance was universal in character, the activation during all the life cycle phases becomes important only in certain projects characterised by high social and economic values. Consequently, the responsibility for project execution does not lie only on the private consortium, but the responsibility of the public sector is also implied.

A characteristic example of the responsibility of the state is the case of the Metronet Rail company of Great Britain. This London public-private partnership that managed the underground railways ended in administrative failure, hence the public authorities had to come forward and give £2 million to save the company from bankruptcy. The company was then retaken into public ownership [10].

The commonest solution is to establish an interdisciplinary team that will continually monitor and control the development of the project and the quality of the serv-

ices provided. Thus in each phase of the project life cycle the safety and quality measures will be ensured.

This role is important because it allows for the project performance to be assessed, which provides an information feedback and the communication of the completed existing programme or project with the future decisions on the projects and programmes, as well as the economic development strategy. Depending on the type and size of the infrastructure, the role of the state may include a set of activities related to expropriation of land, issuing guarantees, payment of infrastructure services, but also a large number of other activities throughout the project life cycle.

### **5. Concession holder's role in the concession contract implementation**

The project company established for the purpose of engaging investments into the infrastructure project, on the basis of the contract on establishing the economic entity, is called the concession holder. According to [5], this company includes the sponsors, and these are usually construction companies and financial institutions, organized in the form of a consortium that is in charge of the project execution and expects to gain certain commercial benefits from such a project.

The aim of setting up this company is to participate in the public bidding, therefore it is established as early as the preliminary phases of the project execution. The purpose of the company is to raise financial means and other resources necessary to execute the project. Usually an economic company is established which is directly capitalized by the sponsors' funds and has narrow and time-limited goals. The science on project financing terms this consortium a special purpose entity.

The investors into large and capital intensive projects, as are infrastructure projects, require that the special purpose entity is formed in order that the credit risk should be restricted to specific projects, that specific goals of designing, construction, management and maintenance of infrastructure facilities are fulfilled as well as that infrastructure services should be provided. It is in this sense that the isolation of project risks creates the environment in which there is no danger of other risks emerging from the business activities the investor cannot envisage [3]. However, the special purpose entities may be established to more undesirable goals, such as avoiding tax payments and concealing the sponsors' transactions. According to [12], the attention of professional and academic public is especially focused upon the abuse of the special purpose entities after the failure of the Enron power corporation bankruptcy in 2002. An improper use of the entity and a fraudulent accounting

reports, accompanied by an inadequate audit performed by the then auditing giant Arthur Andersen, conditioned the changes in the concept of special purpose entity reporting.

According to [8], the key principle of public-private partnership is that risk should be allocated to a partner who can manage this risk in the best way. Actually, one of the most important principles of project financing as a modality of financing individual business enterprises is in the advantages this approach has in comparison with direct financing because the risk can be more easily and simply anticipated and allocated to certain participants in the business operations. An effective allocation of risk has a direct financial effect upon the project, which results in lower overall project costs and in an increased so-called value for money in comparison with the traditional method of financing and execution. The aim is not to transfer the risk to the private partner, but to distribute it equally so that the overall costs be minimized. The project financing is specific in terms of risk distribution, since the risk to be taken by the concession holder, the conceder or a third party (such as insuring company) is defined in the course of negotiations.

The risk allocation in the infrastructure projects financing is not an abstract phenomenon. Usually, the risks taken by the public or by the private sector are defined imperatively, by law or by contract, agreed upon by both the concession holder and the conceder. For example, the risk of land expropriation completion is the risk taken by the public sector. On the other hand, the risk of material provision, construction and maintenance of infrastructure facilities is by a rule taken by the private partner.

The guidelines proposed for the risk allocation further in the text are not obligatory nor are they universally applicable; they rather describe a generic model of the concession contract. Different concession contracts may assume different systems of risk allocation, therefore, the situational approach in risk allocation is the best one. We will, however, describe some general directives for an optimum risk distribution.

Risk is most commonly defined for different phases of the project [28], such as the risk of infrastructure design, the selection of the contractor(s), the construction of the infrastructure facility, or provision of infrastructure service, facility management, etc.

The selection of the contractor(s) is of great importance for an efficient execution of the infrastructure project. The basic criteria in the selection of the contractor are the pre-project experience in the relevant field, significant references, and the reputation on the market. If the project is executed abroad, it is necessary that the con-

tractors know the local market and maintain good contacts with local manufacturers/suppliers. Even though a certain form of insurance is included when the contract is being closed, the damage in case the project fails may be outstanding. In some cases, the contractor may be the project sponsor itself. Then we deal with the conflict of interests and the risk of making inadequate contracts. In case there are flaws in the tender specification, the consequences of such errors are by a rule taken by the public sector. The errors in designing infrastructure systems are assigned to the contractor and it is these errors that cause an erosion in the returns on investments.

In the construction phase, the key deviations that may emerge in the project implementation are related to the hypertrophy of costs, disregard of the anticipated time limit for the completion of the project, and the disparity between the project effects and the criteria set in the designing phase. A similar classification according to the construction phases is used by Abdou [1], who classifies the risk as regards the financial, the time and the design aspects.

The cost exceeding risk analysis deals with the most important cost items in the project budget, the manner in which the costs are controlled, and the possibility that they can be exceeded. If the budget is exceeded due to the inefficient practices in the construction or the departure from the planned costs, the logics of concession mechanism states that such increased costs are to be suffered by the private contracting party, since the consortium is in charge of control of such expenses. Possible disparities in the input buying prices, or costs, which the consortium deems uncontrollable, do not always have a clearly defined party that will bear them. Such excess costs are usually suffered by the project company, although specific clauses may be included to define in more detail which inputs are key inputs in the production and thus the risk of higher prices of these inputs can be distributed more evenly. As regards all the activities of the state that affect the project in a specific way, such as delays in licence issuing and work approvals provision, they are the responsibility of the conceder, i.e., the public authorities themselves. The cost control in the project construction is requested by the financiers, who have to approve of any rise in the key costs, even in case when there is sufficient capital to complete the project. The project company is entitled a certain freedom to manage minor variations of costs falling into main categories, the more so if the total project costs are not fixed, but are of fluctuating character.

According to [22], the empirical evidence show that the mechanism of public-private partnership and the concession itself have great advantages compared to the traditional methods of infrastructure construction in cases of

construction within the planned time. For example, the UK National Audit Office reported in 2003 that 76% of audited public-private partnership projects were completed and available to use within the time period stipulated in the contracts. On the contrary, only 30% of traditionally financed and realized infrastructure projects were completed by the deadlines stated in the contract [24]. The causes of delays in project construction and the postponing of project completion may be due to the contractor's or the supplier's failing to fulfil their obligations, to the factors pertaining to force majeure or to the third party factors. The deviation from the planned time of construction should be treated as the failure of the concession holder in case it results from an inefficient practice of construction or weaknesses in the manufacturers' coordination. On the other hand, in case the delays are the consequence of the so-called force majeure, the time penalty should be transferred to the insurance company, on condition the project is insured. The risk of the force majeure refers to the impacts of factors in the domain of the force majeure, such as strikes, floods, fires and other natural catastrophes or technical failures that may result in the reduction of capacity or may stop the project functioning temporarily or permanently. The project is also exposed to risk from the force majeure during both the construction period and the period of operation.

In case the project fails to satisfy the criteria set in the tender documentation, e.g., in case of the unsatisfactory quality of infrastructure services or defects in infrastructure facilities, the liquidation damages will be the liability of the concession holder. The risk of poor performance means that the project (due to poor design and inadequate technology) does not perform as expected. Such risk and consequently increased costs will have a significant impact upon the returns on investments, i.e., upon the profitability of the project itself.

## 6. Conclusion

Creating an adequate business environment for the development of partnership between the public and the private sectors becomes imperative for the growth and development of national economies. This need is especially evident in the developing countries. The roles of the state in creating regulatory and investment encouraging elements of the business environment for the inflow of private capital in the infrastructure projects realization are manifold and complex. They range from highly general, such as the regard for the principles of the state based on the rule of law, to the specific demand for efficient institutions for the selection of concession holders. Of primary importance for the functional concession mechanism is that the risk be optimally allocated among the conceder, the concession holder, and other contracting parties. The principle to be followed is

that the responsibility and the consequential risk should be assigned to the party that can manage the given specific risk in the best possible manner. It is in this way that the total costs of financing and execution of the infrastructure project are minimized and all the interested parties are given opportunity to maximize their returns on investments, in purely financial, but also in broader socio-economic contexts.

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