Manage Fiscal Risk of Public-Private Partnership (PPP)

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Fiscal commitments of PPP include direct and contingent liabilities

- "Direct" liabilities (DL) are those where the need for payment is known—these could include an up-front capital payment or regular payments (such as availability payments) over the lifetime of the contract.

- "Contingent" liabilities (CL) are those for which payment is needed only if some uncertain future event or circumstance occurs—so the occurrence, value, and timing of a payment may all be unknown.
  - PPPs undertaken by State-Owned Enterprises (SOEs) also create CLs for the government.

There are four sub-types of direct and contingent liabilities

Direct Liabilities

- Up-front viability payment
- Associated works
  e.g. feeder roads for a toll road project
- Annuity or available payments
- Shadow tolls or output-based subsidy
  e.g. subsidy per km driven on a toll road

Contingent Liabilities

- Guarantees on particular risk variables
  E.g. risk in variability of service tariff
- Force majeure compensation clauses
- Termination payment commitments
- Credit guarantees
  E.g. guarantee on project company's debt

Fiscal commitments often create risks to fiscal systems, because of lacking assessment, awareness and management of commitment result…

- Commit without adequate assessment on projects
  - Inadequate project design and poor investment decisions
  - Lack of proper economic analysis of PPP projects
- Commit for “wrong” reasons
  - Commitment made only to defer government payment but not to achieve long-term project efficiency
  - Governments may prefer contingent liabilities to other obligations., as governments usually can incur contingent liabilities without budgetary approval or recognition in the government’s accounts.
- Uninformed impact of commitment on fiscal health
  - Contingent liabilities create management problems for governments. They have a cost, but judging what the cost is and whether it is worth incurring is difficult.
  - Contingent liabilities are not reflected in government account

Some Asian Countries faced serious risks from inappropriate commitment of fiscal contribution to PPP

- In the midst of the 1997 Asian crisis, several Asian countries suffered exacerbated impacts due to PPP CLs that transformed into immediate obligations. Such problems may have been more effectively addressed if the Ministry of Finance had assessed the fiscal obligations of these deals at approval

- Fiscal liabilities from financing infrastructure project created systematic risks to banking sector

Korea

- Government didn't take action in intervening problematic investment program

Indonesia

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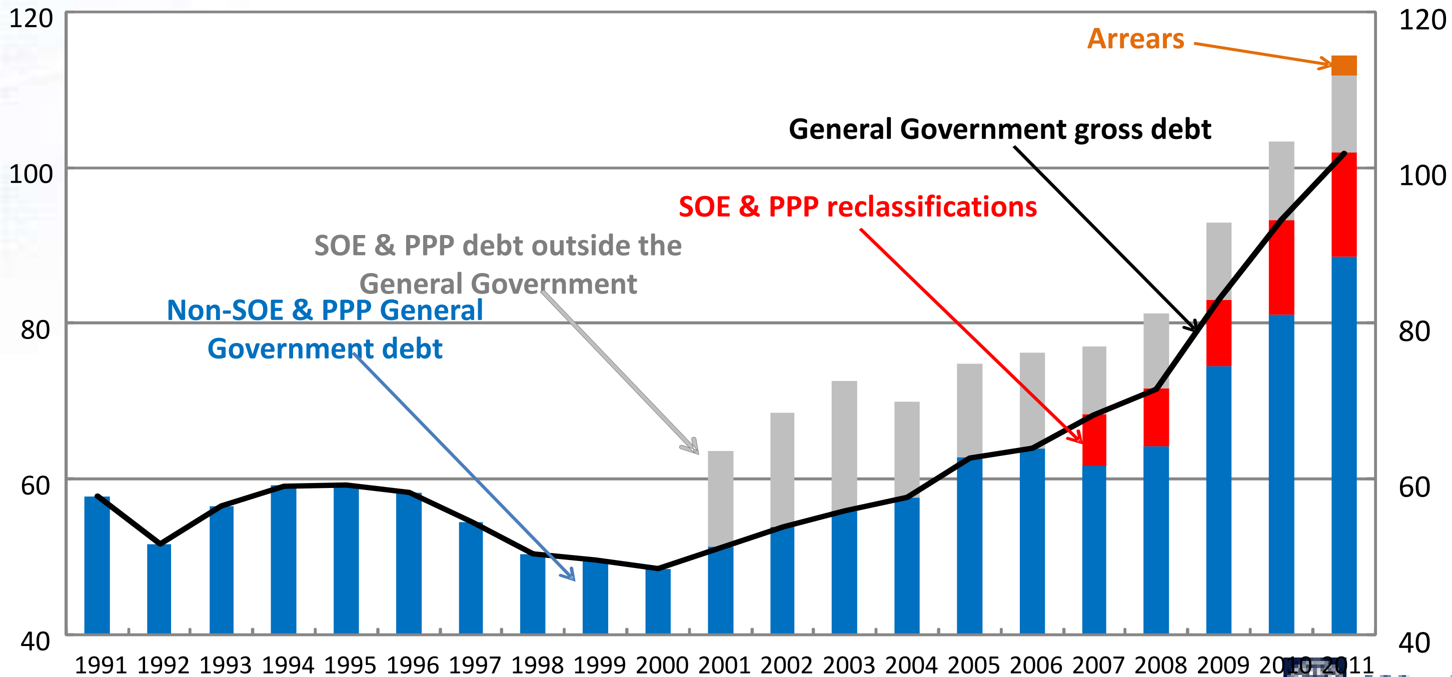
Inadequate consideration of fiscal implication of PPP also aggravated economic crisis in Portugal

Portugal's recent crisis has been exacerbated by the fact that the government had to make large payments to PPP companies as a result of PPP contracts developed in the years before the crisis without adequate consideration of their fiscal implications.

Figure 1: General government debt in Portugal



*Only includes Central Government SOE debt pre 2007

In PPP practices, some Chinese governments used to make fiscal commitments beyond their affordability, mainly because…

- An over-promise phenomenon
  - Governments overlooked technical and management qualification of concessionaires
  - Governments overpromised guarantee of return
- Governments are not fully aware of contingent liabilities, and government accounting balance sheet do not include contingent liabilities as mandatory
- Lack of a comprehensive management framework of fiscal commitment of PPP covering up-stream project due diligence, and down-stream risk management.

Central government recent policies indicate the direction of managing fiscal risks of PPP

- *Notice of Promoting and Utilizing Government and Social Capital Collaboration* issued by MOF in Sep, 2014:
  - Identify proper payment mechanism, financing and subsidy plan while conducting project
  - Select proper partner and allocate risk to the one with best risk-bear capacity
  - **Improve management of fiscal subsidy and provide subsidy based on project performance, with integrated consideration of service price, construction cost, operation cost, actual return, and medium to long term fiscal affordability**
  - Strengthen risk management of local government debt
  - Enhance project performance evaluation

- *Directive on Strengthening Local Government Debt Management*, issued by State Council in Oct. 2014:
  - Include fiscal subsidy to projects of government and social capital collaboration into government budget management.
  - **Budget repayment of contingent liabilities** that sub-national government or their affiliated institutions are responsible for.

International experience recommends a full-cycle management of fiscal risks of PPP

Prior-PPP

- Defining clear roles and responsibilities within government for managing fiscal commitments of PPPS throughout the project cycle

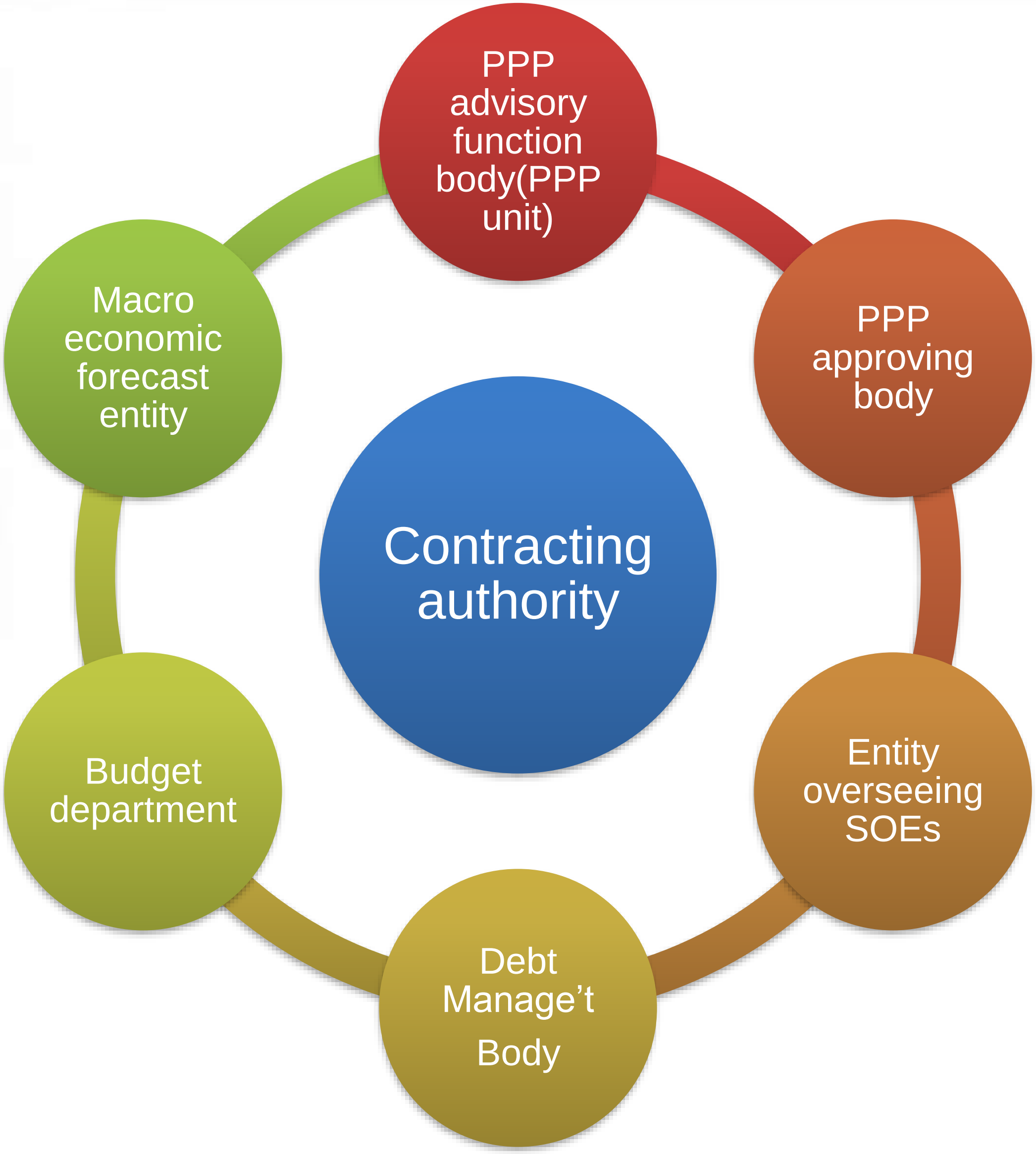
PPP development

- Building the requirement to assess and approve fiscal commitments into the PPP development and approval process

PPP implementation

- Monitoring fiscal commitment at a project and portfolio level, reporting and disclosing them as part of regular government financial reporting, and budgeting for them as needed.

First, an effective inter-department cooperation should be established with clear roles and responsibilities defined to assess, monitor and respond to fiscal commitments



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Institution	Role and responsibilities
Contracting authority	Government agency or SOEs that appraise projects from all aspects; Identify fiscal commitments and budget, monitor and respond to fiscal commitment over the life of project
PPP project advisory function (PPP unit)	Formulate PPP policy and provide technical assistance in PPP Help develop standard contract clauses and guidance on manage fiscal commitments, and monitor PPP program accordingly
Debt management department	Often set in MOF to assess and advise on fiscal commitment on a long-term liability management perspective Manage fiscal risk, incorporate updated fiscal commitment into debt and fiscal sustainability analysis, undertake scenario analyses and stress tests
Budget department	Often set in MOF to assess and advise on fiscal commitment affordability from a budget priorities/constraints perspective; Document fiscal commitment, allocate and release budget for DL and CL, create provisions for PPP contingencies and fiscal rules to respond to contingencies
Macro economic forecast entity	Often set in MOF to assess and advise on fiscal commitment from an overall liability and macro management perspective; Assess possible adverse impact of excessive sub-national exposure to fiscal commitment
Entity overseeing SOEs	Set in MOF or as a stand-alone entity, to assess and advise on SOE health and exposure to PPP commitment Monitor SOE performance in PPP contract, and review implication to government budget and expenditure
PPP approving body	Finance Minter with veto power and supported secretariat, to approve PPP project, draft contracts, tender rules and renegotiation of PPP, based on all rules listed

Secondly, an assessment of fiscal cost should be conducted by taking both direct and contingent liabilities into consideration, when developing PPP projects

Ensure project feasibility and provision of value for money

Allocate risks, define viability gap and payment mechanism

Identify fiscal commitments(both DL and CL), and estimate their costs

Assess affordability of fiscal commitments in light of budget and liability management

Ensure assessment of fiscal commitment feeds into PPP approval process

Shared risks" may be a relevant source of contingent liabilities. Insufficient transfer of risk to the private partners results in low incentives for project performance, creating rents for private parties. But excessive transfer of risk to private partners (in contract provisions) may act in a counterintuitive way by creating large implicit contingency costs for government.

✓Compare annual cost estimates against projected budget of contracting authority

✓Consider the impact on debt sustainability

✓Introduce specific limits on different types of PPP commitment

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Examples of explicit limits on PPP fiscal commitments

Some countries have introduced explicit limits on PPP fiscal commitments. The United Kingdom, for example, has specified individual departmental spending limits for each department, ranging from 6 to 7 percent of total annual spending. Brazil's current PPP law prohibits undertaking new PPPs if the projected stream of payments under the overall PPP program exceeds 5 percent of government revenue in any future year. In Greece, current payments of approved PPP projects account for 6–7 percent of its public investments program are expected to reach 10–12 percent in five years, and are ultimately capped at a limit of 15 percent.

In India, an inter-ministerial task force was constituted to recommend budgetary ceilings for annuity commitments under PPP projects. The task force's September 2010 report proposed that the sum of total annuity commitments for a particular grant or scheme of any department for the next five years should not exceed 25 percent of the department's current five-year plan outlay of such grant or scheme. However, no cap is set for guarantees issued to PPPs.[a]

Note: for other examples of ceilings for PPPs in El Salvador, Hungary, and Peru, see Funke, Irwin and Rial (2013), "Budgeting and Reporting for PPPs," OECD/ITF Joint Transport Research Centre Discussion Paper 2013/07.

[a] India Planning Commission (2010), "Report of the Task-Force on Ceilings for Annuity Commitments."

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Thirdly, both direct and contingent liabilities should be reflected government financial book and budgeted in the fiscal plan

Maintain up-to-date records of fiscal commitments and manage risk factors

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Include fiscal commitments into debt reporting and other fiscal reporting system

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Ensure DL and realized CL paid and budgeted

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Create budget flexibility for other CLs (e.g. contingency line)

✓Gather information from concessionaires
✓Determine whether and when to recognize PPP FC as government liabilities
✓Define how to treat SOE obligations under PPP contracts in reporting and accounts

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While budgeting fiscal commitments, governments may consider three ways of budgeting respective to type of fiscal commitment

- Budget direct and ongoing commitment: build the payment requirement into the annual budget allocation of relevant departments
- Budget long-term PPP commitment:
  - a medium-term budget framework
  - commitment budgeting
  - A two-stage budgeting process- approval in budget planning and determining way to finance
- Budget contingent commitment:
  - creating additional budget flexibility by including a contingency reserve in the budget that can be used to meet calls on contingent liabilities;
  - "insuring" against the need for such payments by creating a fund upfront from which contingent liabilities will be paid (as in Colombia)

The whole fiscal management system of PPP requires strong and complete legislation.

Providing regular access to performance information throughout the life of the project:

Assigning the obligation of monitoring PPP fiscal commitments to a particular government entity

Publishing PPP contracts and disclosing information on PPP fiscal commitment

Implications to China's next steps in managing fiscal risks of PPP

- Assign fiscal management responsibilities to government institutions engaging in PPP, and ensure fiscal risk at each stage to have a responsible body
- Identify and evaluate direct and contingent commitments and relevant fiscal costs, as well as estimate the impact on fiscal health and sustainability
- Adopt accrual-accounting standards for financial reporting and ensure the government books reflecting both direct and contingent liabilities
- Improve budgetary system to capture the cost of contingent liabilities, and also use multi-year fiscal plan for budget fiscal commitments
- Strengthen legalization of managing fiscal commitments of PPP and enhance information disclosure

Thank You!