

ADB Webinar: Fiscal and Debt Management of PPPs



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FISCAL AND DEBT MANAGEMENT OF PPPS

- **Introduction**

- PPPs— Procurement method, risk sharing arrangement or source of new funding for fiscally-strapped governments?
- PPP as a procurement method potentially providing Value for Money
- PPP - an easy fix for governments facing large infrastructure spending gaps, high debt levels and fiscal constraints?

- **Why Are PPPs Potential Sources of Fiscal and Debt Mismanagement?**

- Do PPPs really ease fiscal constraints and provide “free” infrastructure?
- Sources of fiscal illusion
- Inadequate fiscal risk assessment – PPPs give rise to both direct and contingent liabilities

- **Key Steps to Effective Fiscal and Debt Management of PPPs**

- disclosure, transparency and above all sound governance
- Integrating PPPs with the medium-term budget process
- Managing contingent liabilities

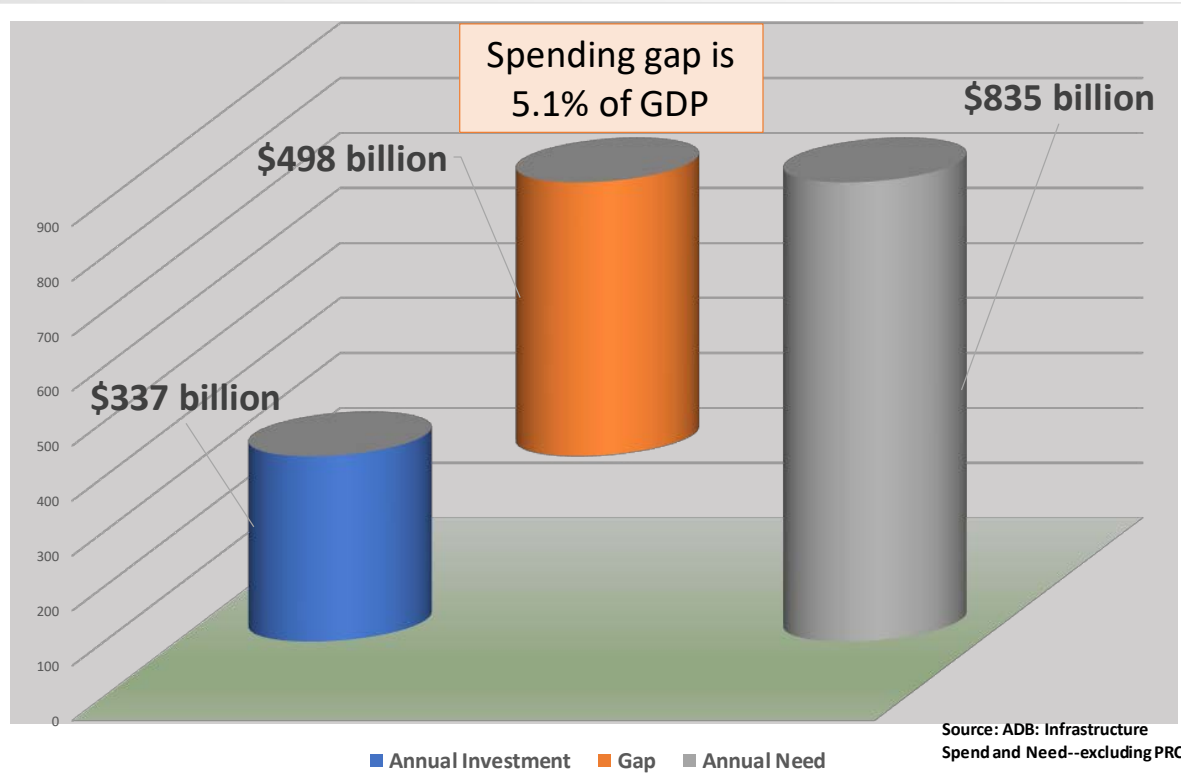
- **Conclusion**

INTRODUCTION

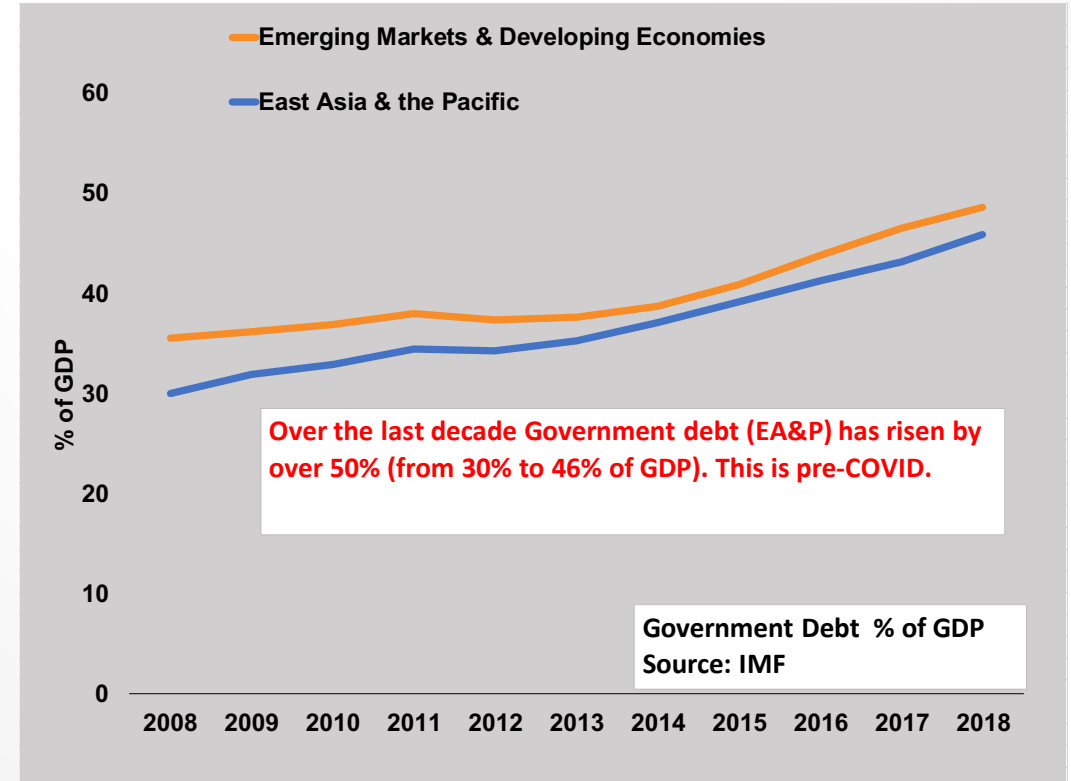
- What are PPPs – A procurement method, risk sharing arrangement or source of new funding for fiscally-strapped governments?
- Why do governments undertake PPPs? What problem do they believe they solve?
- What are the real potential benefits of PPPs?

Why do Governments undertake PPPs?

MASSIVE INFRASTRUCTURE GAPS



RISING DEBT LEVELS



What do Governments say about PPPs?

- **Indonesia** – “Overcoming the limitation of Government budget for infrastructure needs” – MOF / PPP Unit
- **Cambodia** – “we need to ease the burden on the national budget and the participation of the private sector is very important in this” – Permanent Secretary of State commenting on progress with the PPP draft law
- **Philippines** – “Senator Poe reminded policy makers of the opportunity of the financial advantages of PPP over government-funded projects – the shifting of project costs from the taxpayer to the user of the project’s services” – Senator Grace Poe, Chairperson of the Senate Committee on public services

What are the Potential Benefits of PPPs

- PPPs is a way to **finance** and deliver an infrastructure project (i.e. a procurement method)
- PPP is not a new source of **funding** for an infrastructure project
- PPPs can offer Value for Money (VfM) and deliver infrastructure effectively and efficiently
- They do this if they harness private sector incentives for performance – this is not guaranteed
- This in turn depends on the risk-sharing arrangement in place
 - general rule is that risks should be allocated to party that can best manage the risk at lowest cost
- **The ability of governments to identify, price and manage risks, ex ante AND throughout the project cycle is crucial to achieving VfM from PPP arrangements**
- **The failure to do so is a key source of PPP fiscal risk**
- Not new or additional risks—the same risks that occur under Government provision of infrastructure
- **These risks are often ignored or disregarded – governments lack the institutional and capacity requirements to manage them effectively**

WHY ARE PPPS POTENTIAL SOURCES OF FISCAL AND DEBT MISMANAGEMENT?

- Do PPPs really ease fiscal constraints and provide “free” infrastructure?
- The difference between financing and funding
- Sources of fiscal illusion
- Inadequate fiscal risk assessment – PPPs give rise to both direct and contingent liabilities

PPPs and the Illusion of Fiscal Space

- PPPs don't create fiscal space
- They aren't "off balance sheet"—they give rise to actual and contingent liabilities (and assets)
- PPPs cause the illusion of fiscal space because:
 - They are typically developed in an off-budget process that misunderstands the differences between funding and financing; and
 - Governments typically do not properly monitor or account for both the direct and contingent liabilities that arise from these off-budget processes
- The failure effectively to monitor and account for off-budget liabilities leads to a breakdown of transparency and accountability, thereby perpetuating the fiscal illusion

Funding and Financing

Funding

Refers to how the cost of the project, including the cost of finance, will be paid for over time

Only two sources of funding: the government through tax or other revenue or users through user charges

Financing

Managing cash flow timing differences between initial capital cost, operating costs and future revenue

Only two sources of finance: debt or equity

Case Study: the Illusion of Fiscal Space — Mongolia

- In 2008, the Mongolian Government entered into “build-transfer” (BT) contracts for roads
- These were financed by construction companies themselves, usually through commercial borrowing, on the condition of repayment from the budget later by the Government
- BT schemes were considered attractive as spending on them was not reflected in the budget while construction activities were taking place
- The BT schemes for rural roads were particularly expensive and typically overengineered – given the perception that they were “free”
- Typically involved very little transfer of risk – increase in financing costs not compensated with any efficiency gains in delivering the services involved
- Several of these schemes were eventually cancelled as the fiscal costs grew, and this had a negative impact on investor confidence, consequently setting back the country’s PPP program, which only began again very slowly several years later

Sources of Fiscal Illusion

The IMF categorises three main sources of fiscal illusion in PPPs:

- Accounting practices
- Asset and liability recognition criteria, and
- Inadequate fiscal risks assessment by public sector contracting agencies

The fiscal illusion has its roots in poor project governance processes:

- ***the wrong projects are selected and are procured as PPPs***
 - ***And for the wrong reasons***

Accounting Practices Foster the Illusion

- **Cash accounting** allows governments to increase infrastructure investment without an immediate impact on public-sector deficits or debt - no initial investment so no debt or assets on balance sheet
- Through the whole project cycle, the fiscal impact is basically the same, in NPV terms, regardless of procurement method
- For **availability payment** PPPs, the avoided upfront investment is offset by subsequent payments to the private partner to compensate for the costs of construction, finance, and the operation of the asset
- For **user-pay** PPPs, short-term budget savings during construction are equal, in net present value, to the user fees foregone by the public sector during operation

Asset and Liability Recognition Criteria

- Even under accrual accounting public infrastructure can be classified as “private”—not under government control and not required to be disclosed
- Typically this is because for almost all PPPs the legal asset owner is the private sector—often through a maze of complex ownership structures
- Based on the legal ownership of the infrastructure asset, governments may be tempted to exclude PPPs from their fiscal accounts
- Private financing of public infrastructure should not be confused with private ownership
- Does the public sector retain some degree of economic control over the PPPs
 - consider an unsolicited proposal for a PPP toll road funded entirely by users charges—what exactly is the government’s involvement?

Inadequate Fiscal Risks Assessment

- The nature of PPPs can lead to perverse incentives for contracting agencies to procure infrastructure as PPPs in preference to conventional procurement
 - Its not always part of the formal budget process
 - No or weak central oversight
 - Possible to disguise a subsidy as a contingent liability—for example through an unrealistic patronage guarantee
- Poor understanding of PPPs can lead to the actual and contingent liabilities they create to be poorly managed, disclosed and indeed hidden from scrutiny

PPPs give rise to Actual and Contingent Liabilities

- Actual liabilities—the payments the government must make for the service
- Contingent liabilities—the payments the government must make when certain events happen such as termination
- Contingent liabilities fall into two categories:
 - Explicit contingent liabilities—those defined in the contract
 - Implicit liabilities—those that arise from the ultimate obligation to provide the service

Actual Liabilities

- Actual liabilities—those defined in contract that must be paid for the service.
- Examples include:
 - Availability payments for a road or building
 - Payments for electricity generated under a power purchase agreement
- Fiscal, budget and affordability impacts need to be transparent and understood well before contract execution
- Can create substantial fiscal problems
 - Deferral of payment during construction phase creates build up of future fiscal obligations that may be beyond a country's fiscal capacity
 - Failure to budget adequately for long-term direct commitments — contractual obligation makes it difficult to simply stop providing the service
- Requires a high degree of central control (Finance Ministry) so that total liabilities are managed

Explicit Contingent Liabilities

- Explicit contingent liabilities are dependent on a future event defined in the contract occurring. Examples include:
 - Compensation if regulator/government doesn't approve tolls/tariffs
 - Compensation if government builds competing road
 - Compensation if government decides to terminate
- Guarantees are a special case of explicit contingent liabilities. Examples include:
 - Minimum revenue/patronage guarantees
 - Debt guarantees
- Need central agency oversight so that the full liability position is known, managed and monitored
- Contracting agencies may have incentives to agree to excessive CLs or guarantees during negotiation as they perceive it as off-budget and unlikely to occur
- CLs can also be implicit subsidies—a revenue guarantee for an unrealistically high patronage

Implicit Contingent Liabilities

- Contingent liabilities don't have to be in the contract
- Implicit contingent liabilities arise due to public expectations and pressure of interest groups – this is the idea of the government as **the risk bearer of last resort**
- Examples include:
 - default of a sub-sovereign and public and private entity on non-guaranteed loans
 - other liabilities such as environmental damage, buyout, bailout, etc.
 - default of the central bank on its obligations to allow repatriation of capital and profit
- What happens if the PPP company issuing motor vehicle licenses fails?
- What happens if the PPP company issuing passports fails?

Crystallisation of PPP CLs

- IMF study identified the average fiscal cost of PPP CLs was 1.2% of GDP with a maximum of 2% of GDP
- This was based on an analysis of 80 countries, including 46 EMEs over the period 1990 to 2014 and identified 8 instances of CLs crystallising
- However the study ignored PPP CL realisations that were less than 0.2% of GDP as not being macro relevant
- The average fiscal impact of 1.2% of GDP is material given that the ADB forecasts that GDP growth in developing Asia will be 6.2% in 2021
 - that is CL realisation would equate to a 20% reduction in GDP growth
- External shocks – GFC and most recently the Covid 19 crisis – can wreak havoc on PPP projects
 - In such circumstances, the shocks are likely to impact **all PPPs all at the same**, giving rise to substantial crystallization of CLs

Innovative Approach to CL Management – NSW, Australia

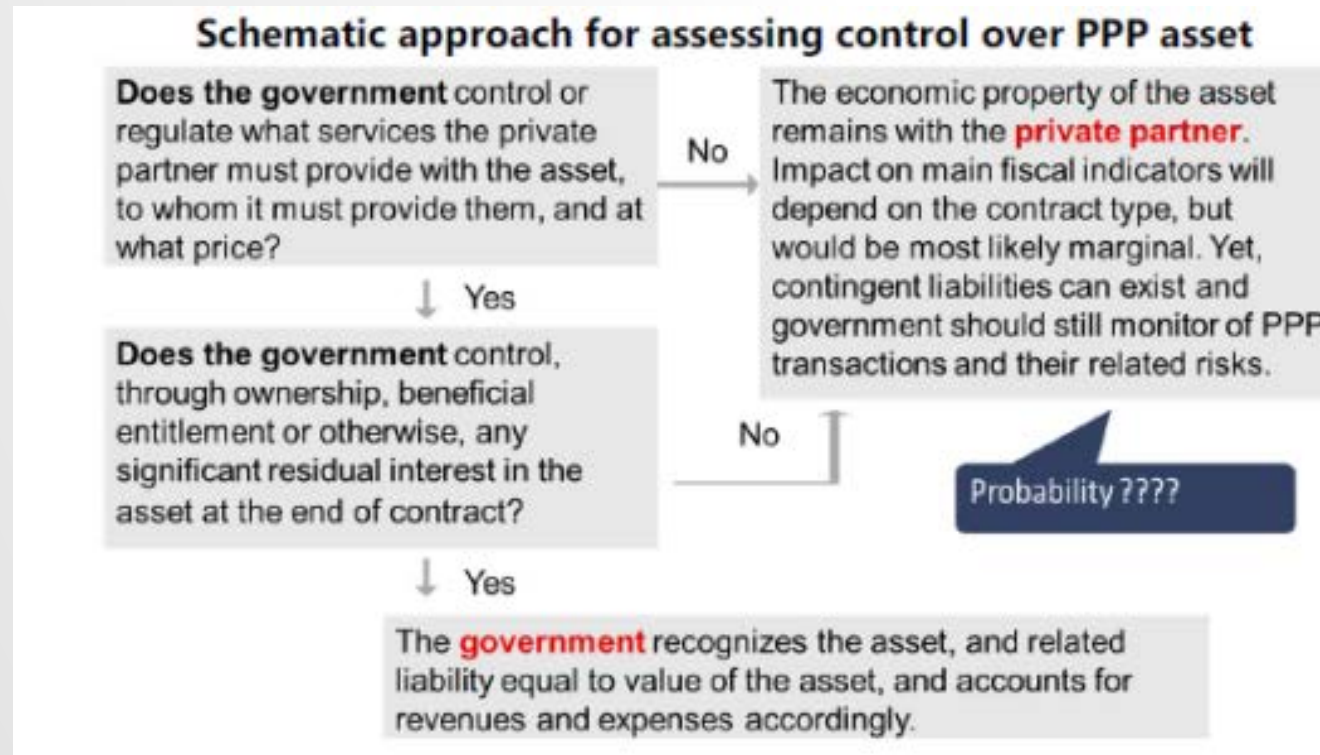
- Australia's biggest urban road project, WestConnex:
 - \$11 billion
 - 33 km, including 19km of tunnels
 - links Sydney's west and south-west with the city and airport
- Unique procurement approach: Government Buys, Tolls and Sells (GBTS)
 - Government sets up motorway company
 - Company issues bond to pay for first phase and imposes a toll
 - Procures private contractor who assumes construction risk via incentive and penalty arrangements
 - Gathers traffic data
 - Raise further debt against future toll revenues
 - Spend debt on next phase
 - Gather traffic data
 - Sells equity
 - Recycle equity capital into future phases

KEY STEPS TO EFFECTIVE FISCAL AND DEBT MANAGEMENT OF PPPS

- **Disclosure, transparency and above all sound governance**
 - Accounting standards, GFSM, PFRAM, IMF FTC
- **Integrating PPPs with the medium-term budget process**
- **Managing contingent liabilities**

Accounting Standards—PPPs

- IPSAS32 recognises that PPPs create assets and liabilities similar to traditional procurement
- The test for recognition focuses on control



- Even an unsolicited toll road PPP should be disclosed under this test

Accounting Standards—Guarantees

- IPSAS 19 require that:
 - If there is more than a 50 percent probability that a guarantee will crystallise and the amount can be reasonably estimated—a provision (liability) should be recognized in the financial statement
 - An expense is recorded in the operating statement and an equivalent liability in the balance sheet
 - . In the case of existing guarantees - previously disclosed as contingent liabilities - provisions are recognized in the accounting period in which the change in probability occurs
 - This leads the way to providing for guarantees on a probability basis over time; building up a provision for the once-off payment through an annual expense allocation
 - Payments made in settlement of guarantee claims are set off against the liability

GFS/GFSM Financial Statistics

- IMF Government Financial Statistics Manual broadly follows IPSAS32
- Distinguishes between legal ownership and economic ownership through control and risk tests
- If government is economic owner and there is no significant upfront contribution by the government and the asset reverts to the government at contract end then acquisition of asset is recorded along with a liability similar to a financial lease—example availability payment for a water treatment plant
- If private party is the economic owner, but transfer occurs at the end of the contract then the residual asset can be progressively recognised throughout the contract

IMF PPP Fiscal Risk Assessment Model (PFRAM)

- PFRAM—an analytical tool to assess the fiscal costs and risks of PPPs through a structured process for gathering information following a five-step decision-tree:
 - Who initiates the project?
 - Who controls the asset?
 - Who ultimately pays for the project?
 - Does the government provide support to the private partner?
 - What does the PPP contract risk allocation tell us about the macro fiscal risks?
- Provides standardised results:
 - project outcomes on a cash and accrual basis
 - With/without debt sustainability
 - Sensitivity analysis of main fiscal aggregates to macro-economic and contract specific changes
 - Summary risk matrix

IMF—Financial Transparency Code

- The code requires that PPP obligations are regularly disclosed and actively managed
- Governments are required to publish annually their PPP rights, obligations, and exposures under PPP contracts.
- For guarantees, the FTC requires that government's exposure is regularly disclosed and authorized by law
- The code introduces three levels of practices:
 - Basic: annually publication of gross exposure under guarantees
 - Good: publication plus authorization by law of the maximum value of new guarantees or their stock
 - Advanced: publishing information on the probability of call on guarantees.

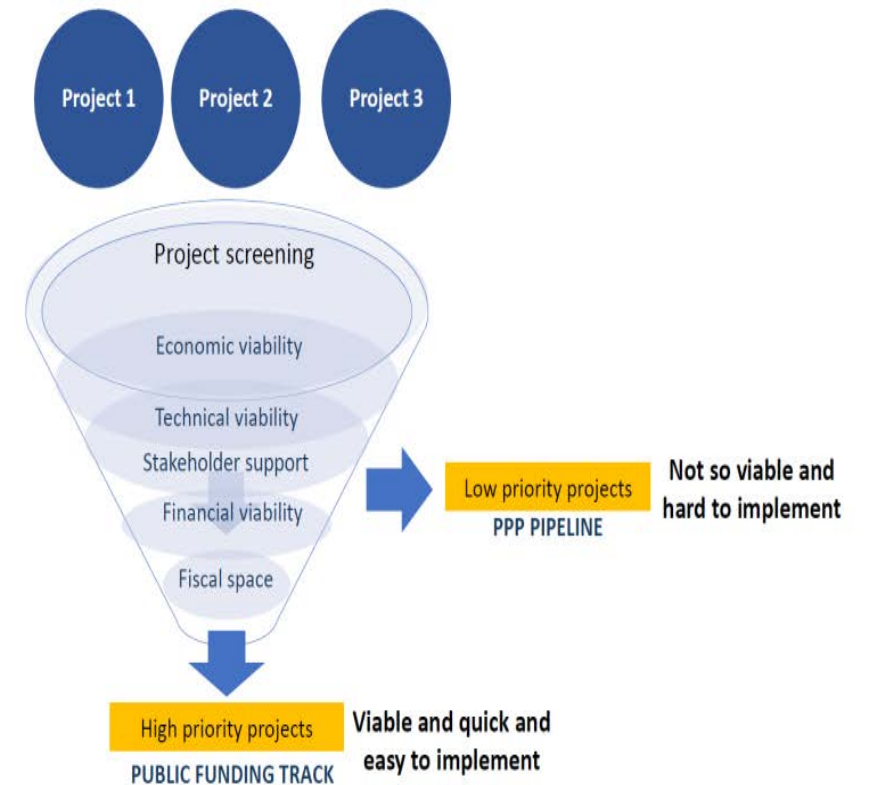
Integrated Development of PPPs

THE BUDGET RULE

- PPPs development should be integrated within the public investment management operational framework and linked to medium term fiscal framework (MTFF) processes
- All projects should derive from a comprehensive medium-term infrastructure planning process that should be linked to strategic economic priorities
 - Governments must be wary of unsolicited bids – how do they fit with strategic economic priorities
- All projects should follow a budget rule – i.e. go through the **investment decision** and only then the **finance and delivery (procurement) decision**
- **Investment decision**—is this project economically and financially justified and the highest priority project? The best use of scarce resources?
- **Procurement decision**—does this project offer VfM if procured as a PPP? Will the costs and risks to government be lower or quality higher than if it were delivered by direct government procurement?

TYPICAL PPP PROCESSES – NOT INTEGRATED

Projects from sector agencies, communities, and other stakeholders



International Examples of Fiscal Cost Management

- Brazil: Ceiling on current spending on PPP contracts of 3 percent of net revenue.
- El Salvador: The PV of the cumulative amount of quantifiable firm and contingent future PPP payments cannot exceed 5 percent of GDP.
- Hungary: annual nominal value of new long-term commitments cannot exceed 3 percent of budget revenues.
- Korea: A cap of 2 percent of Government spending for PPP contracts
- Peru: The present value of contingent and noncontingent liabilities in PPP projects cannot exceed 7 percent of the GDP.

Contingent Liability Management

- Set Limits and Control Usage of Guarantees
- Place limits on the use and quantum of guarantees that are appropriate to the fiscal circumstances.
- Control the circumstances in which guarantees are issued.
 - only where the costs of the guarantee are less than the benefits x percent of the loss.
- Strong, standardised approval process with final approval by a central agency
- Charge guarantee fees to SOEs and contracting agencies —makes the real cost of service explicit

Disclosure of Contingent Liabilities—International Experience

- Common to split into quantifiable and unquantifiable risks (e.g. New Zealand)
- Common disclosure of the list and value (stock) of Contingent Liabilities including guarantees e.g. Philippines, Australia, New Zealand, South Africa
- Disclosure and quantification in fiscal risk statements and budget papers
- Some countries also disclose:
 - List of guarantees expected to be called (Hungary)
 - Expected cost of outstanding guarantees (Philippines, Columbia, Chile)
 - Anticipated flow of new guarantees (Japan)
 - Risk ratings for guarantees (1-10 scale) (South Africa)
- The Philippines has set up a Contingent Liability Fund—that is an annual budget allocation based on the probability of CL realisation of liabilities
 - ADB technical assistance designed innovative approach to determine size of provision, based on simple formula of expected losses = prob [default] x loss given default
 - Projects were given risk rating, depending on sector, project phase (construction, early operation, mature operation, etc.) and loan currency
 - Proposed a guarantee fee to be borne by implementing agency to reflect that there is a cost associated with providing guarantee – equivalent to portion of CL Fund provision for which IA was deemed responsible

CONCLUSION

- **Key takeaways**

Key Takeaways

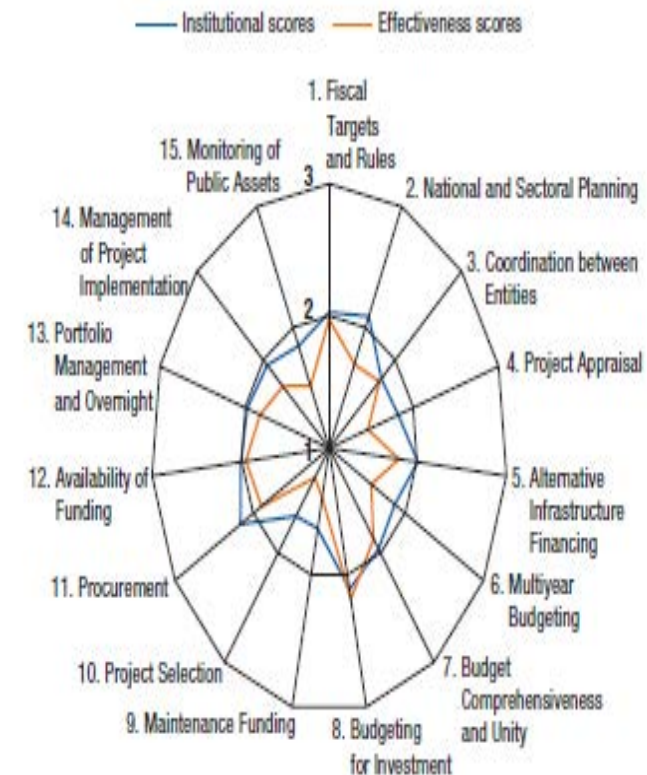
- Stop feeding the 'fiscal illusion' through communication policies and operational practices when it comes to PPPs
- Stop targeting downstream, transaction level support to PPP Units
 - if the projects are the wrong ones to begin with it makes no difference how much capacity PPP Units have to procure them as PPPs
- Investment in institutional capacity development should be targeted not on the downstream or transaction advisory stage but rather at the upstream and mid-stream stages
- Specifically, PPP projects should:
- Follow a “budget rule”, wherein “investment” decision precede “procurement” ones
- Be integrated within the public investment management operational framework and linked to medium term fiscal framework (MTFF) processes

Key Takeaways

INFRASTRUCTURE GOVERNANCE IS KEY

- Focus on project governance—the end to end process. PPPs are a component of an integrated process
- Good project outcomes depend critically on both the design and effectiveness of institutions that govern PPP planning, allocation and implementation
- The IMF's Public Investment Framework (PIMA) is a useful framework for evaluating infrastructure governance and covers the three stages of the public investment cycle: planning, allocation, and implementation
- PIMA shows weakest areas—where ADB support would have maximum benefit

PIMA IN ASIA



Source: IMF Public Investment Management Assessment missions, 2015–19.