

International Seminar on
Strengthening Public Investment and Managing
Fiscal Risks from Public-Private Partnerships

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PPP and fiscal risks

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Overview

- PPPs and fiscal risk reduction
- PPPs and fiscal risk increase
- Managing fiscal risks:
 - Gateway processes
 - Non-naïve approach to risk

Public-private partnerships

Basic characteristics of PPP:

- long-term (whole-life) contracts between public and private partners
- assumption of risk (long-term risk) by the private partner

PPPs and fiscal risks

risk reduction

- long-term contracts are able to check cost overruns (rely on private sector management, allowing public sector to focus on quality and service)
- payment structure may check time overruns

PPPs and fiscal risks

risk increase

- the public sector presents significant asymmetries in bargaining power and in the ability to manage the relationship
- the long-term characteristic of PPP contracts reduces the incentives to contain fiscal risks

Two sources of fiscal risks

- the characteristics of public service (that weaken the position of the public sector)
 - o inherently unavoidable (but should be subject to specific risk management procedures)
- perverse incentives arising from using long-term contracts in a short- or medium-term budgetary framework
 - o may be controlled, requiring a specific framework for PPP-project appraisal and a specific budgetary procedure (or a full long-term budgetary appropriation scheme).

Fiscal risks arising from the characteristics of public service

- public authorities are supposed to keep the public service running once it starts operating
 - the public sector will always try to avoid service disruption → the private partner may use this in order to strengthen its bargaining position
- the Govt' ability to assume and accept risk (any kind of risk) is almost infinite
 - whereas in private-private relationships, any deviation from the optimal risk allocation will disturb the project and jeopardise the profit-maximisation of some players, in PPPs those deviations that will shift risk toward the public partner will not affect any private player.

Procurement problems

- Private players are usually better prepared than government departments to negotiate, manage and renegotiate PPP contracts, because they are focused on project output and outcomes
- Public procurement rules requiring transparency and fairness force public sector entities to operate under a strict procurement framework

Lack of a long-term budgetary framework

- PPP payments' profile is not well accounted for by short-term budgetary appropriation mechanisms.
- Risk-transfer clauses generally provide for payments to start only after construction of infrastructure (or provision of other long-term assets) is concluded → payments will be zero for the first four years, and then the payments profile will be smoothed for the whole life of the project.
- The main decisions on the project – to go on with it, to call for tender, or to close the contract – will be made between six and four years before starting the payments → no payment will be made by the incumbent government.

Lack of a long-term budgetary framework

- PPP projects will not be subject to appropriation, and will thus tend to be perceived by public decision-makers as zero-cost projects, jeopardising the efficient selection of projects.
- Some non-priority projects could be selected because – as all projects are perceived as zero-cost projects – the selection will tend to be made on the basis of benefits, not on a cost-benefit basis.
- Even worse, governments may be induced to approve projects that on a cost-benefit basis would never be accepted.

Lack of a long-term budgetary framework

- The usual appropriation mechanisms designed to cope with current expenditure and traditional procurement of capital projects no longer apply
→ Line ministers cannot be made accountable for long-term projects that generate a long-term flow of payments starting only outside the scope of the current legislature and government.
- Moreover, as project payments will typically burden ministers not responsible for the project's approval, these ministers may be perceived as sharing in the responsibility, thereby creating pressure to put those PPP projects outside the line-ministries' budget commitments.

Efficient assessment of risks

- Being long-term contracts, subject to a significant range of uncertainty (technological, financial, commercial, even political), PPP-projects present special difficulties in the assessment of expected costs, probability of implicit fiscal risks and their impact.
 - This assessment is specialised and costly. In the absence of a budgetary framework that requires an explicit assessment procedure, line ministries will therefore tend to deliver suboptimal efforts in project evaluation.
- Without that explicit assessment procedure, long-term appropriation mechanisms for PPPs – if they are provided for – will not be efficient instruments for fiscal responsibility and accountability

Facing fiscal risks

A double approach for dealing with PPP fiscal risks:

- design some sort of budgetary appropriation or quasi-appropriation, in order to induce fiscal responsibility and accountability;
- create an appropriate assessment methodology (for PPP projects and programmes), in order to check for efficiency and sustainability.

Facing fiscal risks

- Either of these can be developed in a more rigid or flexible way, with more or less direct control of the Finance Ministry or the Parliament, depending critically on the kind of institutional developments and on the institutional role of the Finance Ministry.
- From the efficiency and sustainability viewpoint, PPP projects and programmes require political and administrative responsibility by the involved line ministers and ministries, as well as a careful appraisal by the Finance Ministry (evaluating and appraising expected costs and fiscal risks).

Facing fiscal risks

- In the absence of a long-term budget, and in the absence of strong control mechanisms by the Finance Ministry, a simple and effective scheme relies on a **gateway system** that includes:
 - a **quasi-appropriation process** and
 - **appraisal processes** addressing efficiency and fiscal risks.

The gateway process

A gateway process is an institutional arrangement that would empower the Finance Minister to stop or suspend a PPP project or programme if certain conditions are not met.

- It formally gives the Finance Minister veto power to stop a PPP project that does not provide efficiency or that could endanger overall fiscal discipline.
- It keeps responsibility for policy design in the hands of the sponsoring line ministry, but provides a certain degree of filtering by the Finance Minister.

The gateway process

- Gateways need to be installed at specific stages of preparing, negotiating (and renegotiating) a PPP project.
- By allocating specific responsibilities to the Finance Minister and the Finance Ministry, the gateway process ensures that key project steps and decisions are systematically communicated to the Finance Ministry and enables it to halt a project or request modifications to it when certain risks are deemed too great for budgetary purposes.
- Final approval by the Finance Minister is required before contract signing.

Gateway phases

A simplified gateway will require:

- a pre-procurement phase (involving project assessment by PPP experts and the Budget department, as well as the final approval of the Finance Minister of the contractual scheme and tender documents)
- a procurement phase (involving preferred bid assessment and final approval of the contract by the Finance Minister)
- a new gateway for each possible renegotiation process.

Phase 1

Planning, design and preparation of tender

- the Project Team prepares the initial feasibility study, undertakes the public sector comparator analysis, and prepares tender documents;
- PPP Unit assesses efficiency and overall sustainability, and reviews tender documents;
- Budget Dept evaluates budgetary affordability and ensures consistency with overall fiscal goals and priorities;
- the PPP Unit and the Budget Dept report to the Finance Minister, recommending rejection of the project if inefficient or unaffordable.
- **Gateway 1:** the Finance Minister approves or rejects the project.

Phase 2

Bidding and negotiation

- the Tender Board assesses bids and selects the shortlist; negotiates with the shortlisted bidders; selects the preferred bidder;
- the PPP Unit assesses the draft PPP contract, checks risk-sharing and efficiency, and reports to the Finance Minister;
- **Gateway 2:** the Finance Minister approves or rejects the contract.

Phase 3

Construction and operation

- the PPP Unit monitors implementation, based on regular reports by the project manager;
- the Budget Department monitors budgetary aspects on a regular basis;
- if renegotiation is needed, the Finance Ministry is invited to join the process; the PPP Unit will assess efficiency and overall sustainability; the Budget Dept will ascertain budgetary implications and ensure consistency with overall fiscal goals and priorities. Both report to the Finance Minister. **Gateway *n***: the Finance Minister approves or rejects the contract.

Budgetary quasi-appropriation

- PPPs imply the commitment by government to buy certain services
- This translates into a long-term financial profile of net payments from government
- Based on the Public Sector Comparator (PSC), forecasts may be prepared
- PPP memo attached to the Budget (contracted payments, PSC forecasts)

Additional disclosure

- Details of contract provisions that give rise to contingent payments or receipts (e.g. guarantees, shadow tolls, profit sharing arrangements, events triggering contract renegotiation) that need to be valued to the greatest possible extent.
 - critical for risk awareness

Additional disclosure

- Amount and terms of financing and other support for PPPs provided through government lending or via public financial institutions and other entities (such as SPVs) owned or controlled by government.
 - useful but not critical

Additional disclosure

- Information on how the project affects the reported fiscal balance and public debt, and whether PPP assets are recognized as assets in the government balance sheet. The emphasis is on ensuring that PPP assets are effectively accounted for and not kept in limbo.
 - increasing standardisation of national accounts and PPP accountancy rules

Non-naïve risk analysis

- Current and future participants in the design, procurement, and management of PPP contracts have their own objective functions:
 - Prospective private partners;
 - Line ministers and ministries;
 - External consultants;
 - Government departments.

Non-naïve risk analysis

- Private partners will try to engage in strategic behaviour.
- Incompleteness, if not properly addressed, may open the door to pernicious strategic behaviour.
- Rigidity, on the other hand, should be avoided.

Importance of risk analysis

In the absence of a proper risk-analysis, the ex-ante assessment of PPP contracts allows for:

- (a) the underestimation of costs and risks, and
- (b) a trade-off of perceived costs against non-explicit and non-valued risks.

Importance of risk analysis

- Optimal rules for risk sharing will depend on a proper risk assessment, as quantitative as possible; but even the qualitative assessment of risks is useful. In many cases, the simple identification of risks (project error, licensing, demand, renegotiation...) is critical to the efficiency of the project, because the mere possibility of transferring some significant cost to the public sector will induce private partners to strive for that transfer.

Importance of risk analysis

- A careful assessment of the main fiscal risks will thus associate to each project its costs and risks, reducing the incidence of project selection risks.

Eurostat risk assessment

- As a rule, we should say that an efficient PPP project will be classified by Eurostat as off-balance sheet.
- but classifying the assets of a PPP as either public or private does not adequately capture fiscal risks.

Eurostat risk assessment

- too much focus on simple rules like the “on/off” balance sheet Eurostat test provides strong incentives to tailor a project to “pass” the Eurostat test (i.e. allowing it to be recorded off-balance sheet), rather than to gear project design toward the best allocation of risk to achieve efficiency.

Final note

Promoting efficient PPP schemes and guaranteeing fiscal sustainability may be achieved through different combinations of institutional procedures

- all countries promoting PPPs will need some reporting requirements for PPP projects, ranging from a specific memo to a full-scale long-term budgeting scheme;
- all countries promoting PPPs will need a proper management of their fiscal risks, either PPP-specific or integrated in a wider project-management procedure.

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