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# PPP and Fiscal Risks

## Experiences from Portugal

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This paper presents a view on PPP fiscal risks, their assessment and management, reflecting the experience of the author as practitioner and researcher in the field, but also the European experience with this kind of contract. Considering the characteristics of public sector governance and the fundamentals of public-private relationships, gateway processes are presented as effective tools for PPP efficiency and budgetary sustainability.

### 1 Risk in public-private partnerships

Public-private partnerships (PPP) are long-term contracts between a public sector entity and a private sector entity, requiring the provision (by the private partner) of a certain long-life asset (e.g. a highway, a railway or some other public infrastructure, or simply a set of trains) and payment of services (by the public partner, the end-user, or both) based on availability or demand.

The basic efficiency-engine of a PPP is the assumption of risk (long-term risk) by the private partner, not any kind of risk, but specifically those risks manageable by the private partner and whose assumption creates the appropriate incentive for the efficient management of the projects by that partner.<sup>1</sup> Transferring those risks to the private partner should imply transferring also the appropriate tools (legal and institutional) for their management.

In this paper, the term “fiscal risk” refers to potential adverse impacts on the financial position of a public body as a result of factors that affect the performance of a PPP project.

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<sup>1</sup>PPPs are sometimes characterised by resource to private finance. However, efficient risk transfer does not imply full private finance. Transferring risk effectively requires a certain degree of private finance, in order to put private capital at stake. However, public finance may be used in order to allow for private participation in infrastructure in those cases where full private finance is too expensive for the project to present value-for-money.

Because they are long-term contracts designed to transfer significant risks out of the public sector and into the private sector, PPP contracts are **able to reduce fiscal risks**. However, some risks cannot be transferred to the private sector through PPP contracts and, worse, PPP contracts can even **create new fiscal risks**.

The long-term characteristic of PPP contracts reduces the incentives to contain fiscal risks, and so requires a careful approach to their assessment and disclosure. Fiscal risks may not only jeopardise the fiscal stability of the country; in a monetary union, fiscal risks may spill over from one country to the whole union, inducing free-riding behaviour. Assessing risks and disclosing information on them is therefore a matter of common interest.

**The Portuguese experience.** Having been one of the first European countries to engage in PPP for the development of public infrastructure, Portugal has experienced significant success in terms of effectiveness — rapid development of infrastructure, provision of high-quality services to end-users — but a few problems on the budgetary side. Due mainly to environmental problems, delayed urban permits, and project changes required by government, several projects have seen significant cost overruns. Some ex-ante PPP expected costs (e.g. the shadow-toll payments for SCUT highways) have even created fiscal problems because they had not been adequately addressed in budgetary terms, for lack of a long-term budget and lack of specific PPP appropriation (or quasi-appropriation) rules.

The provision for a memo on PPP costs, to be attached to the Budget, was prescribed as early as 2000 in the Budgetary Framework Law, but the absence of significant measures to control PPP commitments led to a heated political debate in 2002, on PPP fiscal risks. In 2003, Decree-Law 86/2003 designed a framework for PPP assessment, establishing a gateway process for PPP projects and several institutional rules for risk assessment (including the computation of a public sector comparator for each project). As a consequence of these developments, Parública's PPP Unit was established on behalf of the Finance Minister. The PPP assessment framework law was reviewed recently, by Decree-Law 141/2006, in order to improve the gateway process. Each year the Budget presents a table including disclosure of contractual or expected annual costs accruing from each PPP project and programme.

## 2 Fiscal risks in PPP contracts

PPP fiscal risks have two main sources: the characteristics of public service (that weaken the position of the public sector as a partner) and the perverse incentives arising from using long-term contracts in a short- or medium-term budgetary framework. The first source of fiscal risk is inherently unavoidable (but should be subject to specific risk management procedures). The second source may be controlled, requiring a specific framework for PPP-project appraisal and a specific budgetary procedure (or a full long-term budgetary appropriation scheme).

### 2.1 Fiscal risks arising from the characteristics of public service

The usual risk analysis for PPP-projects uses a methodology developed for project finance, striving for the careful allocation of risks between partners. Having been developed in the private sector, this methodology disregards two essential characteristics of public-private partnerships:

- The basic characteristics of public service require public authorities to keep the public service running (once it starts operating), giving rise to an inherent asymmetry in the public–private relationship — the public sector will always try to avoid service disruption, and the private partner may use this in order to strengthen its bargaining position. This relative asymmetry will naturally depend on the kind of public service, the degree of government commitment to the provision of the service, and the ability of the government to negotiate and use pre-emptive strategic moves.
- The Government’s ability to assume and accept risk (any kind of risk) is almost infinite, and so risk-sharing rules need to be different from those usually contained in contracts between private players — whereas in private–private relationships (e.g. project finance between private players), any deviation from the optimal risk allocation will disturb the project and jeopardise the profit-maximisation of all (or most) players, in public–private relationships those deviations that will shift risk toward the public partner will not affect any private player.

These two factors are compounded by some deficiencies of public sector procurement and contractual management:

- Private players are usually better prepared than government departments to negotiate, manage and renegotiate PPP contracts, because they are focused (from the very beginning) on project output and outcomes, whereas government departments are usually still trying to move away from the traditional focus on the production of services (concerned with inputs and processes) to the PPP-focus on the real results of the projects (output quantity and quality).
- Public procurement rules requiring transparency and fairness force public sector entities to operate under a strict procurement framework, whereas private players benefit from broader room for manoeuvring. Recent legal developments, aiming at reinforcing transparency and fairness, create additional constraints on already complex procurement processes. For instance, the contracting authority (through the call for tender) commits itself to a certain scheme, which by law may not be subject to significant changes during the tender process — implying the need to prevent possible strategic moves by bidders (exploiting loopholes in the call for tender, or informational asymmetries). In fact, the complexity of PPP procurement (with its negotiation phase) demands a greater effort in the preparation of tender documents, and the strategic management of the procurement process to cope with new but essential procurement regulations.

These last factors may be compensated or corrected by appropriate measures, but the other two factors are intrinsic to the public sector, and must be faced up to and incorporated within any efficient and sustainable approach to PPP development.

This calls for a more *strategic* view on risk management, based on game-theoretical insights and a better understanding of the workings of government.

## 2.2 Fiscal risks arising from the lack of a long-term budgetary framework

**Appropriation.** PPP contracts typically present a profile of payments (from the public sector to the private partner) that 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, so payments will be zero for the first four years, and then the payments profile will be smoothed for the whole life of the project. This implies that 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, implying that no payment will be made by the incumbent government. So in the absence of a specific budgetary procedure for PPPs (or of a full long-term budgetary process) 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.

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. This may be the case if PPP projects' payments are never included in the budget for the first few years — and that will be the typical case, because initial payments will be zero (or even negative, i.e. initial disbursements from the private partner to the public partners, as payment for transferred assets or goodwill), and long-term payments will not be included in short- or medium-term budget documents.

**Efficient assessment of expected fiscal commitments and fiscal 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, because the set of risks considered could be too narrow, and the evaluation methodology applied could be inefficient (for instance, using an excessively large discount rate, inappropriate inflation scenarios; assuming a grossly unrealistic full ability of the government to manage the contract; or disregarding strategic behaviour on the part of private partners).

### 2.3 Facing fiscal risks

Dealing with PPP fiscal risks implies a double approach:

- 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.

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.

The adequate solution depends critically on the kind of institutional developments and on the institutional role of the Finance Ministry. As measures toward controlling PPP-risks affect core matters of policy decision (by ministers and government), some countries rely mainly on the provision of reliable information to the Parliament and to the public (this is the case in Portugal); other countries impose strict limits on aggregate PPP commitments as a percentage of expected government income (the case of Brazil); other countries rely on a tradition of budgetary accountability and the strong role of the Finance Ministry as guarantor of fiscal sustainability.

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).

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 (such as the one developed in Portugal in recent years) relies on a **gateway system** that includes a **quasi-appropriation process** and **appraisal processes** addressing efficiency and fiscal risks.

### 3 Managing fiscal risks in PPP: the gateway process

#### 3.1 Gateway processes

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.

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.

#### 3.2 Gateway phases

Gateways may be more or less detailed and include a large number of phases in which the Finance Minister is required to issue an approval. 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), and a new gateway for each possible renegotiation process.

We present a sketch of a simplified gateway process for PPP projects, assuming the existence of a Project Team (responsible for project development, and staffed by the sponsoring ministry, possibly also including Finance Ministry experts), and of a PPP Unit assessing PPPs on behalf of the Finance Minister.

### **Phase 1: Planning, design and preparation of tender**

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

In Portugal, the PPP Unit is directly involved in the project team from the outset of the project. The Budget Department is not formally required to assess affordability or consistency; however, approval of the project by the Finance Minister requires, according to law, that it had been previously considered in the PPP memo attached to the Budget.

### **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.

In Portugal, the Tender Boards are required to take into consideration the PSC value as a limit-value for contracting: in all calls for tender, the contracting authority reserves the right to cancel the call if all bids surpass a reference value, usually the PSC value or an amount lower than the PSC.

### **Phase 3: Construction and operation**

- the **PPP Unit** monitors the project's implementation, based on regular reports by the project manager;
- the **Budget Department** monitors budgetary aspects of the project's implementation on a regular basis;
- if renegotiation of the contract is needed, the Finance Ministry is invited to join the process; the **PPP Unit** will assess efficiency and overall sustainability; the **Budget Department** will ascertain budgetary implications of the renegotiated draft PPP contract and ensure consistency with overall fiscal goals and priorities. Both report to the Finance Minister, recommending to reject the draft renegotiated contract if found

to be inefficient or unaffordable. **Gateway  $n$ :** the Finance Minister approves or rejects the contract.

In Portugal, the Finance Ministry PPP Unit is directly involved in any renegotiation from the outset. The Budget Department is not formally required to enter the process.

### 3.3 Budgetary quasi-appropriation scheme

PPP contracts imply the commitment by government to buy certain services from a private provider, according to a specified rule or according to effective demand. According to government expectations, this translates into a long-term financial profile of net payments from government to the private partners. Prior to tender, and after designing the outline business case for the project, the Project Team is always able (and legally required, in Portugal) to compute the Public Sector Comparator (PSC) — the expected cost of the project if it were developed under traditional procurement and with no resource to private finance. The Project Team is thus able to compute, taking the PSC as an upper bound, the expected annual net payments to be made by the government to the private partners for the whole life of the project.

The Budgetary Framework Law should require the presentation, in a memo attached to the Budget, of a table with the full annual expected net payments to be made for PPP contracts. This memo should include, at the very least, all PPP contracts already signed, but ideally would also include the expected upper bounds for payments concerning projects already approved (but still in the tender phase).<sup>2</sup>

In Portugal, the Budgetary Framework Law requires the PSC to be computed prior to the project's approval, and its inclusion in a memo attached to the Budget. In practice, the memo includes PPP contracts already signed, projects already approved and still subject to tender, and projects not yet approved but already included in a PPP programme being developed.

### 3.4 Possible additional disclosure requirements

The IMF suggests broader reporting requirements for PPP projects,<sup>3</sup> also presented as a memo attached to the Budget. In addition to the future service payments, the IMF considers that, for each PPP project or group of similar projects, the following information should be provided in the memo on PPPs:

- 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 estimated to the greatest possible accuracy.

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<sup>2</sup>The publication of PSC values and upper bounds for annual net payments is challenged by some practitioners on the basis that it may create an incentive for bidders to use them as target values. Our view is that effective competition will prevent that from occurring — and that, if there is collusion amongst bidders, it is better to have the PSC as limits to contracting. In fact, significant efforts should be exerted toward the promotion of effective competition, as PPP procurement requires more than the usual formal competition clauses.

<sup>3</sup>See IMF, 2005, *Public Investment and Fiscal Policy — Lessons from the Pilot Country Studies*, SM/05/118 (April), <http://www.imf.org/external/np/pp/eng/2005/040105a.pdf>.



- 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.
- 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.

The increasing standardisation of national accounts and PPP accountancy rules effectively provides for the prevention of any ‘limbo’ for PPP assets. The compilation of information on public financing of PPP projects is useful but not critical, as *real* PPP projects will transfer the appropriate risks to the private partners and avoid contamination of public finance mechanisms.<sup>4</sup> Reporting contingent payments is much more critical for risk awareness, as disclosure of this kind of information leads the public eye to matters of risk management by public entities, inducing them to improve the assessment of risk impact and risk probabilities, and to improve prevention measures and risk mitigation. However, for this kind of disclosure, governments will probably need additional improvements to the current knowledge on PPP risk assessment.

## 4 Managing fiscal risks in PPP: a non-naïve approach to risk

### 4.1 Non-naïve risk analysis

A non-naïve approach to risk in public–private partnerships will need to accept that:

- Current and future participants in the design, procurement, and management of PPP contracts have their own goals. In particular,
  - Prospective private partners will not only try to maximise their profit out of the contract, but also to influence the design and parameters of the contract for that same goal;
  - Line ministers and ministries will look for contracts that maximise net benefits, assessed from their own sector’s viewpoint (in a short- or long-term way);
  - External consultants, according to the rules implicit in their consultancy contracts, may or may not have incentives to align with public interests (defined in broad terms or by the contracting entity), or to develop the kind or contractual schemes and procurement processes that best serve their own goals;
  - Government departments may have their own agenda(s), as some of them (the ones more concerned with the procurement of inputs and the definition of processes) will suffer from PPP development, while others (the ones more focused on outputs, outcomes, performance, and quality) will benefit from it.

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<sup>4</sup>In general, Portuguese PPP contracts use 100 per cent private finance. However, we are considering using some public finance for PPP projects — e.g. infrastructure development funds, or a mix of EU Funds and budget grants — in order to optimise large projects in which service payments may be structured according to risk.

- The long-term contractual relationship creates opportunities for the private partners to engage in strategic behaviour in order to extract rents from the public partner.
- PPP contracts are, by nature, incomplete contracts. The incompleteness is not a flaw; it is an essential feature that allows the private partners to manage the project efficiently and to introduce innovation, in a context of (technological, commercial, and political) change. But the incompleteness, if not properly addressed, may open the door to pernicious strategic behaviour.
- Rigidity, on the other hand, should be avoided. The careful allocation of responsibilities and risks is essential, but service definition must be adaptable to changes (technological, commercial, political etc.). Contracts must take into consideration that no one can consider all possible future changes needed in a contractual relationship, even some that will not be compatible with the contracted partnership (or not compatible with its economy), and so they should provide for the possibility of easy termination (subject to prescribed, unambiguous rules for compensation) after a certain number of years.
- As PPPs ultimately deal with the provision of public service, any threat of disruption will affect the contractual relationship, increasing the bargaining power of the private partners.

None of the factors mentioned above are new, and occur in other cases. The difference in the case of PPPs is that because PPP contracts delay and smooth the flow of payments from the government to private partners, the *perceived* impact of costs and risks is reduced, effectively allowing costs and risks to be shifted from present to future generations, and inducing too much risk acceptance by governments.

## 4.2 The importance of risk analysis

In this paper, we do not intend to present guidelines on risk analysis, but only to improve awareness about several sources of fiscal risks that are commonly neglected. 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.

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 is critical to the efficiency of the project, because in many cases the mere possibility of transferring some significant cost to the public sector will induce private partners to strive for that transfer.

Contracts should therefore be designed in such a way as to maximise benefits from cooperation between public and private players, but always seeking to prevent strategic behaviour by private players that could affect the public interest.

A proper risk analysis will also take account of the fact that occasionally accepting too much risk is tantamount to accepting *no* risk — if a partner accepts more risk than it is able to manage, in fact that risk becomes a problem for the other partner. As an example, consider a private partner that accepts unmanageably high (and non-appraised) environmental or demand risks. The public partner might then face the extreme case of having to choose between “helping” the private partner (which might even be performing well, despite its difficulties) or let it fail.

Another example: a minister who engages in PPP contracts involving costs and risks that could, in the future, affect a significant fraction of his Ministry's budget, knows well that this will be a common problem for the government, not an isolated problem for his individual Ministry. It is simply the public finance version of the well-known saying, "If my arrears balance amounts to ten thousand euros, I have a problem; if my arrears balance amounts to ten million euros, the bank has a problem."

### 4.3 Some examples of fiscal risks

**Project error risk.** Design errors or misspecifications made by the public partner may lead to low-quality project or cost overruns (to be transferred to the government). The main cause for cost overruns in traditional procurement comes from "project errors," such as design errors in the architectural and engineering plans presented by the public party to the private party for inclusion in the contract. If and when the private partner is asked to correct these errors by the public partner, compensation claims arise from the former, directed to the latter.

In Portugal, this kind of risk has been contained, because in most PPPs, private partners are responsible for the provision of services to the end-users, and are thus responsible for the consequences of any project error.

**Project selection risk.** This is the risk of selecting public infrastructure projects that do not provide value-for-money, or the risk of not selecting the best projects. As PPP contracts are long-term agreements that typically do not involve payments in the first few years, their selection process avoids, in practice, the (one-year) budgeting appropriation process. If these projects are considered to be zero-cost and there is no specific PPP "appropriation" in the budget, low-social-profitability/high-cost projects tend to be wrongly selected in their stead, as the high-cost component is discounted away. This risk is linked to overall affordability risk, the risk of excessive pressure on the government budget, creating a burden on future generations.

For example, some shadow-toll highways in Portugal are considered to be low benefit/high-cost projects. Originally, they were approved and contracted as shadow-toll projects because they were perceived by decision-makers to be zero-cost projects. Recently, faced with a significant cost burden on the Budget, the Portuguese government decided to apply tolls to those roads. Had cost and benefit been explicitly evaluated, other highway projects, with much lower cost-benefit ratios, would probably have been chosen.

**Licensing risk.** This is the risk of delayed or overly restricted issuance of permits or licenses. If not addressed prior to tender call, licensing risks (including environmental licenses and local authority licenses) may substantially increase the overall cost of a PPP project. Transferring licensing risk to the private partners is costly, as bidders put a high premium on this risk. Retaining this risk in the public sector, as typically occurs, has two main consequences: (i) the government has to pay for unforeseen project changes required in the licensing process; and (ii) private partners (by default not subject to competitive pressure) are able to obtain economic rents from these changes. Licensing risks mostly come into play when certain environmental standards need to be respected, but are not properly accounted for prior to tender; and when local authorities are

interested parties in the development of a PPP, or at least are allowed to benefit from the project (for instance, through the associated construction of city infrastructure to compensate for the “impact on the community”). In these cases, their commitment to the project should be secured prior to tender — otherwise, they will enjoy some veto power during tender or even after contract close, generating additional project costs, most likely paid by the public partner.

For example, most highway PPPs in Portugal experienced cost overruns and delays due to changing environmental regulations and tendering projects without prior environmental licensing. The €5.5 billion highway contracts have so far generated claims (or claim requests) of €1.5 billion, mostly as compensation for licensing delays, related largely to environmental impact assessments. Light rail projects in Portugal are also suffering from the consequences of veto power by local authorities, eager to collect their share of benefits. With its investment plans almost realised and track implementation almost finished, some months ago the South-Tagus light-rail system had its rolling stock parked, being unable to start tram operations because some crucial mid-way stretches of track could not be built for lack of local government permits; another light-rail project, in Coimbra, had its tender cancelled because of disagreements between the involved local authorities.

The current framework law for PPP assessment does strictly prohibit the launching of PPP projects prior to obtaining all licenses, namely environmental licenses and local authority licenses.

**Demand risk.** The risk that the demand for a service does not match the levels planned, projected or assumed; depending on the specific stipulations in the PPP contract, this can have an impact on the fiscal position. Initial efficiency assessments are essential for understanding this risk. When a government signs contracts requiring payments between public and private parties depending on demand, there is an explicit fiscal risk, as final payments may actually be quite different from projected ones. This risk should be carefully evaluated during the preparation of the PPP scheme and tender documents, during bid evaluation, and throughout the life of the contract.

For example, the initial Fertagus contract (for cross-Tagus suburban rail passenger service) formally transferred demand risk to the concessionaire, but provided for the government to assume debt in case traffic turned out to be below the lower traffic-band level for several years. When this materialized, the contract ended up having to be renegotiated, with the government being in a relatively weak position.

The Portuguese Court of Auditors (*Tribunal de Contas*) recommends avoiding the transfer of demand risk to the private partners, considering its cost and the inherent risks.

**Renegotiation risk.** This is the risk of accepting back some costs and risks (due to information and bargaining asymmetries) whenever the government needs to engage in renegotiation with the private partner. In principle, renegotiations can be a useful instrument to address any contract shortcoming. In practice, their high incidence (and cost for the government) suggests opportunistic behaviour of concessionaires. In order to avoid this, contracts should prescribe rules for renegotiation in the event that unforeseen situations arise. Renegotiation risk is linked to bankruptcy risk, the risk that the concessionaire may go bankrupt, forcing the government to immediately call for a new tender or assume operations of the PPP. As this risk may result in

disproportionate costs to a government, contracts need to include provisions for the swift transfer of the PPP to another private partner.

The Portuguese experience shows that although in certain circumstances the public partner is able to keep some bargaining power — for example, cases in which the private partners need to care for a good reputation, or show-off the ability of the private sector to deliver high quality at low cost through PPP projects — in general the private partner is in a stronger position whenever the government feels the need to renegotiate a contract.

#### 4.4 A note on Eurostat risk assessment

As a rule, we should say that an efficient PPP project will be classified by Eurostat as off-balance sheet.<sup>5</sup> However, one should also be aware that classifying the assets of a PPP as either public or private does not adequately capture fiscal risks. The simple “on/off” balance sheet treatment developed by Eurostat provides strong incentives to design 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.

## 5 Additional notes

**Institutional development.** Besides establishing a gateway process and improving risk analysis, the efficient use of PPP contracts also requires setting up robust institutions and strong legal frameworks — matters not addressed here. Their goal is to provide for the identification and assessment of PPP projects, for comprehensive accounting and reporting systems, and for the efficient management of the long-term relationship between public and private partners. Establishing those robust institutions will create some feedback results, as PPP-focused institutions will, by nature, be outcome-focused and quality-focused entities, caring for the public interest — for the proper definition of public interest, for its measurement, and for its contractual management.

**Sub-national governments.** In most countries, the first wave of PPP projects has been delivered by the national governments. Recently, however, as PPP experience has increased and new markets have been established, sub-national governments are increasingly using PPP schemes, and in some countries (e.g. Spain and Italy) some regional or municipal governments are leading PPP development. National governments must take into consideration the macroeconomic consequences of sub-national PPP programmes and projects, assessing their impact on national accounts and macroeconomic stability, and preventing free-riding behaviour under tight public budgets.

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<sup>5</sup>One could improve the Eurostat classification, however. For instance, some assets, e.g. costly tunnels in densely populated areas, have a very long lifetime, but it is not efficient to design PPP contracts with a similar lifespan — for assets like this, a case could be presented for designing an initial concession contract with positive final residual value, to be paid by the winner of a subsequent concession contract; this would require some kind of government commitment for buying asset services after the end of the initial concession contract.

## A email

Regarding budgetary appropriation for PPP projects and programmes:

1. PPPs require special care regarding the budgetary process because, without proper control, they provide an effective way for approval and launching of public investment projects without guaranteed sustainability. PPPs allow for the transfer of cost from the current generation to future generations, and specially from the current government to future governments, because typically there are no payments in the first three or four years after contract close.

2. Because of the problem above stated, another problem may occur: as projects are perceived by current public decisors as zero-cost projects, the selection of projects looses rationality, allowing for the approval of projects presenting social benefits lower than total costs.

3. A third problem: PPPs, being long-term contracts, tend to create a fiscal burden on the shoulders of Treasury (Finance Ministries), not on line ministries. Specially if PPP projects are not the core projects or activities of a line ministry, because then the ministry is able to fight for additional money to pay for those core, critical projects, besides paying for PPP financial commitments.

4. A fourth problem: line ministries with difficulties in obtaining capital for their projects may be tempted to use PPP procurement when there is no value-for-money in its use, just because it creates (common) government commitment for the long-term payment of contract commitments, including maintenance expenses, and so alleviates current expenses of the ministry, allowing for the transfer of current expenditure for new projects.

5. Those problems may be mitigated by a strong civil service bureaucracy, or by an efficient gate way process for PPP appraisal and approval. Some governments, specially those with a stable and effective tradition of medium-term budgetary appropriation (e.g. the UK), rely on general control mechanisms (for instance, informal long-term budgetary control by the line departments of a strong, powerful Treasury). Other governments, with weaker budgetary control and less powerful Treasuries, need to develop specific procedures for PPPs, through stricter frameworks (e.g. the Portuguese appraisal and gateway procedure approved by the Government in 2003 and reinforced last year; or the Brazilian budgetary limits for PPP commitments by sub-national governments)

6. The zero-cost perception implies a double approach: improving the identification and evaluation of cost, benefits, and fiscal risks; and designing a long-term appropriation mechanism.

7. Regarding fiscal risks. The PPP project cycle should guarantee that the expected net cost of the project for government is carefully evaluated and that fiscal risks are not only evaluated by also mitigated through the introduction of the appropriate contractual clauses and incentive mechanisms (both for private contractors and for public sector contract managers and other public stakeholders). As different government departments (and public decision-makers) present different incentives for the disclosure or camouflage of those costs and risks, the project cycle needs to include a mix of departments that guarantee the appraisal of projects according to the public interest (in its plural variants).

8. Regarding budgetary appropriation. The costs and risks identified need to be aggregated and presented to the public and specially to the parliament, as they involve the risk of shifting cost from present to future generations. More than a rigid control of PPP budgetary commitments, a soft (but powerful) dissemination of information creates the appropriate check on PPP costs

(and so generates enough incentive for efficient project selection). An effective mechanism is the presentation of a table with the contracted or expected costs for each PPP project and PPP programme, for each year of their contracts. That table should be presented in a memo attached to the State Budget, as it refers to future years not covered by the formal appropriation law. (An alternative would be a formal plurianual budget, not envisaged by any country, as far as we know.) In Portugal, the law requires that a PPP project can only be approved if it has been previously included in that Budget memo table. The table includes not only costs for projects already contracted, but also for projects being procured and also for projects subject to consideration by the government. This implies that the preparation of a PPP project requires computing a public sector comparator, and including it in the Budget memo table (or alternatively present an initial estimate for the whole PPP programme and include it in the Budget memo). Anyway, for a project to be approved by government, it needs to be considered in that Budget memo. This is a strong condition, because by decision of the government, published in the PPP-appraisal framework law (a decree-law), PPP contracts should not be signed if the net present value of net payments by government is higher than the public sector comparator that serves as a basis for the Budget memo table. (This links explicitly budgetary appropriation and proper evaluation of costs and fiscal risks.)

9. There is another viewpoint on fiscal risks, related to the risk of aggregate fiscal unsustainability. There is almost no known work on this problem. It deals not only with the sum of individual project risks, but also with the correlation of those risks: project with fiscal risks highly positively correlated create higher risk for a government; negatively correlated risks reduce risk.

10. A warning: Focusing on PPP fiscal risks and PPP appropriation, and providing solutions to them, typically creates a (relative) bias against PPP. It is natural: improving requirements for efficiency and implementing a gateway process for PPP projects induces some public decision-makers to rely more on traditional procurement (faster and less controlled, even if less efficient). In Portugal, that move was clear after the approval of the PPP appraisal framework in 2003, forcing the government to create in 2005 a similar appraisal procedure for every public investment project larger than 200 million euro (around 5 billion euro).

Those were just a few comments that I will elaborate later. (Sorry if there are some typos...)