



# PHILIPPINES: MANAGEMENT OF CONTINGENT LIABILITIES ARISING FROM PUBLIC-PRIVATE PARTNERSHIP PROJECTS

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Printed in the Philippines.

ISBN 978-92-9257-639-4 (Print), 978-92-9257-640-0 (PDF)  
Publication Stock No. RPT168566

#### Cataloging-In-Publication Data

Asian Development Bank.

Philippines: Management of contingent liabilities arising from public-private partnership projects.  
Mandaluyong City, Philippines: Asian Development Bank, 2016.

1. Public-private partnership. 2. Contingent liabilities. 3. Philippines. I. Asian Development Bank.

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# Acknowledgments

This paper was prepared during 2013–2014 by a team comprising Aziz Haydarov, public–private partnership (PPP) specialist at the Southeast Asia Department of the Asian Development Bank (ADB) and Vaughn Montes, ADB staff consultant.

The team greatly appreciates the support of the Bureau of Treasury of the Philippines and the Philippines PPP Center during the work on the study. The team thanks Alex Sundakov and Michael Schur of Castalia Strategic Advisors, Australia, for providing peer review to the study. The team also gratefully acknowledges the review and inputs by Cecilia Soriano, ADB staff consultant, to the later version of the paper.

The findings and recommendations of the study were discussed at ADB on 27 December 2013 and at the Fourth Regional Public Debt Management Forum in Tbilisi, Georgia on 23–25 April 2014.

The study is part of ADB’s analytical and advisory work on strengthening the fiscal management of PPPs in the Philippines comprising the technical assistance on Strengthening Public–Private Partnerships in the Philippines (TA7796-PHI) and Strengthening Evaluation and Fiscal Cost Management of Public–Private Partnerships (TA8650-PHI), as well as the ADB-supported Expanding Private Participation in Infrastructure Program that covers the period of 2014–2017.

This study reflects information as of December 2015.

# Abbreviations

ADB	Asian Development Bank
BESF	Budget of Expenditures and Sources of Financing
BOT	build–operate–transfer
BTR	Bureau of Treasury
CAG	Corporate Affairs Group
COA	Commission on Audit
DBCC	Development Budget Coordination Committee
DBM	Department of Budget and Management
DOF	Department of Finance
DOTC	Department of Transportation and Communication
DRMO	Debt and Risk Management Office
GDP	gross domestic product
GFI	government financial institution
GOCC	government owned or controlled corporation
ICC	Investment Coordination Committee
IFI	international financial institution
IFRS	International Financial Reporting Standards
IMF	International Monetary Fund
IPP	independent power producer
IRRs	implementing rules and regulations
IT	information technology
LGU	local government unit
MOF	Ministry of Finance
MPW	Ministry of Public Works
MRT-3	Metro Rail Transit-3
MW	megawatt
MWSS	Metropolitan Waterworks and Sewerage System
NAIA	Ninoy Aquino International Airport
NEDA	National Economic and Development Authority
NPC	National Power Corporation
PPP	public–private partnership
ROW	right-of-way
VGF	viability gap funding



# Abstract

In 2010, the Government of the Philippines successfully initiated reforms to revive the national public–private partnership (PPP) program. These efforts have resulted in the award of nine PPP projects (total investment of \$3 billion) by 2015, up from six PPP projects awarded from 1992 to 2010. The project pipeline increased from 11 projects (\$3.3 billion) in November 2010 to 45 projects (\$23.2 billion) in March 2015. Given the rapidly expanding PPP project portfolio and based on past lessons learned, the government needs to improve management of contingent liabilities arising from the PPP contracts. Among areas where improvement is needed are (i) the process and criteria for approving contingent liabilities at project level, (ii) management of contingent liabilities at portfolio level, (iii) setting prudential limits for contingent liabilities to ensure fiscal and public debt sustainability, and (iv) addressing investor concerns related to government ability to manage appropriation and liquidity risks in case of materialization of contingent liabilities.

The government has already initiated reforms to strengthen the institutional framework for managing contingent liabilities arising from PPP projects. Among these reforms are (i) establishment of an inter-agency Contingent Liability Monitoring Group headed by the National Treasurer, (ii) setting up a Contingent Liability Division within the Debt and Risk Management Office of the Bureau of Treasury, and (iii) inclusion of the Risk Management Program in the Unprogrammed Fund of the national budget.

Based on this study’s findings, among major directions that may require further effort are (i) pricing of guarantees for non-core risks assumed by the public sector partner; (ii) development of standard criteria and wording for acceptable guarantees and contingent liabilities; (iii) adoption of consistent methodology for identification and quantification of contingent liabilities including their costs and benefits; (iv) formal consideration of quantified contingent liabilities in the PPP project approval process; (v) adopting policy and methodology for setting prudential limits on aggregate contingent liabilities arising from the PPP program; (vi) developing a process for provisioning and funding payments for contingent liabilities, including procedures for claiming and payment of materialized contingent liabilities from the Risk Management Program of the Unprogrammed Fund; (vii) clarification of public sector accounting for PPP projects’ direct and contingent liabilities; and (viii) setting up disclosure standards and procedures for contingent liabilities at project and aggregate levels.

In the medium term, it may be expedient to set up a contingent liabilities fund that would be financed through budget appropriations, and contributions from implementing agencies and project proponents. Such fund would provide a reliable pool from which disbursements on government obligations on materialized contingent liabilities that have to be timely paid in accordance with the provisions of PPP contracts. Budgetary allocations and contributions to the fund would need to be permanent and their availability should not lapse, if not disbursed during the fiscal year. Proceeds of this fund would need to be invested in risk-free highly liquid assets. Establishment of such fund will help adequately address the appropriation and liquidity risks and hence ultimately reduce the cost and increase the value for money of PPP projects.



## INTRODUCTION

In 2010, the Government of the Philippines relaunched the public-private partnership (PPP) program to address major infrastructure gaps that critically constrain Philippine economic growth and development. The PPP program seeks to mobilize private sector resources to augment the government's fiscally constrained infrastructure investments and to derive value for money through more efficient delivery of infrastructure by the private sector.

The current PPP program also seeks to learn from the indirect costs and mixed outcomes from some PPP projects in the past. The excess capacity contracted in the early 1990s in dollar-denominated take-or-pay power purchase agreements with independent power producers (IPPs) led to high energy costs while the new power plants were only partially dispatched. The economic recession and exchange rate depreciation triggered by the 1997 Asian financial crisis translated these losses into huge stranded costs and stranded debts for the government. The failure of one of the two concessionaires of the Metropolitan Waterworks and Sewerage System (MWSS) to deliver on its commitments to extend service coverage and reduce losses exacerbated by the Asian financial crisis eventually resulted in the termination of the concession after difficult renegotiations with the sponsor and creditor banks. The high returns guaranteed in dollars granted to the sponsors of the Metro Rail Transit-3 (MRT-3) project versus very low passenger fares prescribed for populist considerations created large and still ongoing fiscal burdens for the national government. Lack of transparency and poor compliance with the government's own procedures for processing unsolicited proposals set the preconditions for the controversies surrounding the Ninoy Aquino International Airport (NAIA) Terminal 3 project which resulted in the government voiding the contract for alleged gross anomalies even as construction had proceeded for 3 years and the airport was nearly completed.

In July 2010, the government introduced a renewed focus on the PPP approach as a strategy for infrastructure development with a shift in emphasis to solicited projects consistent with, if not drawn from, the Philippine Development Plan. The government also expanded the types of projects that could be procured through the PPP mode to include classrooms, hospitals, airports, urban transport hubs, and information technology (IT) solutions for urban rail ticketing.

To complement the policy emphasis for solicited bids, the government undertook capacity building initiatives focused on a reorganized PPP Center which assists implementing agencies in identifying projects and preparing quality pre-investment project studies.

The government also embarked on parallel activities to strengthen the policy framework for the PPP program through a review of the Build–Operate–Transfer (BOT) law and its implementing rules and regulations (IRRs). The government is currently undertaking policy studies to clarify the rationale for public support for private infrastructure projects including viability gap financing, the proper allocation of risks projects, and the approval process for the government’s support and share in PPP projects.

## A. Literature Overview

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References in the literature used in the study can be grouped into four categories: (i) theories, issues, and practices related to government guarantees; (ii) issues and practices in the management of contingent liabilities per se; (iii) more detailed descriptions of country-specific frameworks for managing contingent liabilities; and (iv) studies and reports on the Philippine experience in PPP projects, guarantees, and contingent liabilities.

### 1. Government Guarantees

Irwin (2007) provides a synthesis of the history, theory, and policy issues in giving guarantees in private infrastructure projects. Irwin proposes detailed principles for providing guarantees, cited in Chapter IV, on the appropriate level and type of contingent liabilities at the project level. The study also highlights the issues in accounting for fiscal impact of contingent liabilities which are referred to in Chapter VIII on accounting and disclosure issues.

In *Contract Design in Public–Private Partnerships*, Iossa et al. defines PPP projects as contractual arrangements which (i) bundle project phases into a single contract; (ii) emphasize output specification, (iii) transfer a high level of risk to the private sector, and (iv) have a long-term contract duration. Under incomplete contracts theory and asymmetric information, the paper proposes that risk allocation should have two sets of goals: (i) to give incentives to undertake efficient actions which cannot be directly contracted because these are not immediately observable, and (ii) provide insurance to the risk-averse party against risks which the party is not prepared to take. The paper provides an analytical framework for the risk allocation problem from which the following results are derived: (i) given partners with similar risk aversion, the risk should be borne by the party mostly responsible for the risk and has relatively more control over the risk factor; and (ii) if the parties have

a similar level of responsibility or control over the risk, the risk should be borne by the less risk-averse party.<sup>1</sup> As shown by the experience of Chile, Colombia, and other countries, the allocation of risks in PPP projects changes with the evolution of the macroeconomy, the government's track record in the infrastructure program, etc. Over time, Colombia's guarantees for infrastructure projects became less "onerous" as the private sector was made to absorb higher levels of market risk. The lossa framework lends itself to an analytical treatment of the efficient allocation of risk for a given level of risk aversion.<sup>2</sup> This is applied on a pro forma basis in the Appendix comparing efficient allocation of risks contrasting the degree of risk aversion by the private investors in the early 1990s at the time of the IPP BOT projects and the current period under more favorable macroeconomic conditions.

Focusing on the fiscal consequences and impact on debt sustainability, Hemming et al. (2006) stresses the importance of fiscal transparency in disclosing information on guarantees although it is "unclear how best to reflect in the fiscal accounts the financial impact of fiscal risk associated with guarantees." The study considers the economic principles for and against PPPs. Private ownership is preferred when competitive market prices can be established; government ownership is justified when there is market failure. The PPPs are means to combine the relative strengths of the government and the private sector in providing services that "respond to market failure" and "minimize the risks of government failure."<sup>3</sup> The study refers to recent developments in the theory of ownership and contracting which provide analytical justification for PPPs and the trade-off for the government between quality and efficiency. PPPs would be well-suited if performance standards and specification as the outputs from the project can be enforced in "complete" contracts. PPPs, however, are less justifiable when outputs and overall quality are difficult to measure objectively. The study provides a framework for accounting for risk transfer, and a reference on international accounting standards for contingent liabilities of governments.

## 2. Managing Contingent Liabilities

In Chapter 6 of Irwin et al. (1997), Lewis and Mody suggest the use of the enterprise risk framework for managing contingent liabilities. The paper defines an integrated risk management framework as consisting of: (i) identifying risk exposures, (ii) measuring and quantifying risk exposures, (iii) assessing the firm's tolerance for risk, (iv) strategic decisions on the allocation of capital to support the risk, and (v) risk mitigation and control measures. Lewis and Mody (1997) discuss at length methods for quantifying contingent liabilities and propose a framework for managing contingent liabilities and budgeting for expected costs. They discuss criteria for establishing reserves against risks which would be relevant to proposal below (Chapter VII) to create a fund for contingent liabilities on a pooling concept. The size of reserves required will depend on whether losses will be assessed on an additive or portfolio basis:

**"Additive versus Portfolio Reserve Requirements."** The first decision that a government needs to consider when setting up a reserve for unexpected losses is the measure of unexpected loss against

<sup>1</sup> T. Irwin. 2007. *Government Guarantees: Allocating and Valuing Risk in Privately Financed Infrastructure Projects*. Washington DC: World Bank. p. 20.

<sup>2</sup> E. Iossa, G. Spagnolo, and M. Vellez. September 2007. *Contract Design in Public-Private Partnerships*. [www.gianca.org/PapersHomepage/Contract%20Design.pdf](http://www.gianca.org/PapersHomepage/Contract%20Design.pdf) (accessed 29 March 2012).

<sup>3</sup> Hemming et al. 2006 *International Accounting and Reporting Standards for Contingent Liabilities, Appendix 5. Public-Private Partnerships, Government Guarantees, and Fiscal Risk*. Washington DC: International Monetary Fund. p. 11.

which to capitalize. Under an additive reserve standards, the government calculates the unexpected loss exposure of each of its contingent liabilities (that is, examines the sensitivity of each guarantee valuation to changes in the underlying factors) independently. Then, for a given confidence level and time interval, it determines the amount of unexpected loss it wishes to cover for each guarantee, taking into consideration the opportunity cost of capital. The government then identifies the average cash reserve required to fund these unexpected losses. Finally, the individual cash reserve balances are aggregated to arrive at a total unexpected loss reserve. This additive approach for setting capital or unexpected reserves is supported by bank regulatory capital standards for financial institutions.

The problem with the additive approach for setting unexpected loss reserves is that it fails to account for portfolio diversification—the fact that pooling imperfectly correlated risks will reduce the variance in the expected loss of a portfolio. As a result, the risk of the overall portfolio will be overstated, and more protection against unexpected losses would be provided than originally sought by the government (Merton and Perold 1993). The alternative is to calculate the aggregate loss distribution of the government’s portfolio of risks, using a value-at-risk approach that incorporates cross correlations between guarantee exposures and then set reserves to cover unexpected losses based on the unexpected loss profile of the whole portfolio.<sup>4</sup>

Other components for managing contingent liabilities highlighted by Lewis and Mody are complementary measures to reduce risk such as designing appropriate contracts, minimizing the frequency of financial impact of calls on guarantees, monitoring performance and re-estimating risks. Lewis and Mody cite a “consultative document” of the Philippine government that made recommendations for better management of contingent liabilities by unbundling guarantees and seeking to gradually reduce the level of support as the government established a record of policy performance.

Irwin and Mokdad (2010) in *Managing Contingent Liabilities in Public–Private Partnerships: Practice in Australia, Chile, and South Africa* survey the practices in the captioned countries for the approval process, analysis, and reporting of contingent liabilities. They highlight that these countries rely on project preparation, competitive bidding, and review of PPP proposals by a central unit in the Ministry of Finance (MOF). In South Africa, the MOF is involved in the four stages of the approval process before a contract is signed. In Chile, the measurement and valuation of contingent liabilities are published every year.<sup>5</sup>

A more recent review article by Cerbotari (2008), *Contingent Liabilities: Issues and Practice*, highlights the concern that contingent liabilities could pose a threat to fiscal sustainability. Another concern is that contingent liabilities represent a form of “stealth financing” that enables governments to get around fiscal and financing constraints. Cerbotari also points to the moral hazard from having the government assume contingent liabilities that would reduce the private sector’s incentives to scrutinize the creditworthiness of a borrower or the viability of a project which would increase the chances that the guarantee would in fact be called. Other salient points raised by Cerbotari is listed below.

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<sup>4</sup> C. Lewis and A. Mody. 1997. Management of Contingent Liabilities: A Risk Management Framework for National Governments. In T. Irwin et al. eds. *Dealing with Public Risk in Private Infrastructure*. Washington DC: World Bank. p.161.

<sup>5</sup> T. Irwin and T. Mokdad. 2010. *Managing Contingent Liabilities in Public–Private Partnerships: Practice in Australia, Chile, and South Africa*. Washington DC: World Bank and Public Private Infrastructure Advisory Facility.

- i. The paper identifies the major components of contingent liability management framework as consisting of a comprehensive process to identify and assess risks, ensure the proper risk taking and allocation; the justification for assuming risks based on economics of market failure; and setting maximum limits on financial claims, charging for guarantees, etc.
- ii. Other safeguards in the approval process for contingent liabilities would involve the Parliament or Congress, scrutiny by the national audit offices, budgeting for the subsidy cost of guarantees, disclosure requirements, etc.
- iii. The paper describes contingency reserve funds which some countries such as Chile, Colombia, Sweden, and the US, use as a form of self-insurance against various contingent liabilities including guarantees. Cerbotari points out that in addition to securing financing contingency, funds can make the cost of contingent liabilities more transparent since actual disbursement can be tracked against original contributions to the funds. She also notes that contingency funds can be actual (funded with cash which is invested in financial assets and managed separately) or notional (funded but pooled into the government's general funds).
- iv. Finally, Cerbotari describes the range of institutional arrangements for managing contingent liabilities across countries but which have common elements: centralization in a fiscal policy-making institution; integrating the management of conventional; and contingent liabilities by a debt management office.<sup>6</sup>

### 3. International Practices

Cerbotari's survey covered the contingent liabilities management practices in Australia, Brazil, Canada, Chile, Colombia, New Zealand, Nigeria, Peru, the United Kingdom, among others. There are reference materials that provide more detail on the practices in specific countries.

The General Directorate of Public Credit and National Treasury of the Government of Colombia published *Obligaciones Contingentes: La Experiencia Colombiana* (2011) which describes in detail Colombia's framework for managing contingent liabilities including the evolution of the legal basis starting with the Ley 448 in 1998 up to more recent legislation in 2007. Colombia's framework covers not only PPP projects but also pension funds, non-PPP force majeure, and legal and litigation risks. The publication describes the operation of Colombia's fund for contingent liabilities which is funded by the respective government agencies for the contingent risks that they are exposed to. Another publication, *Contingent Liabilities: Methodologies in Colombia*, provides a more technical treatment particularly on the methodologies for quantifying contingent liabilities.

The World Bank publication, *An Operational Framework for Managing Fiscal Commitments from Public-Private Partnerships: The Case of Ghana* (Shendy et al. 2013), describes the emerging set-up in Ghana under the "National Policy on PPP" recently approved by the cabinet of the Government of Ghana. The report proposes a framework for managing fiscal obligations arising from PPPs that ensures that PPP fiscal costs are consistently identified and assessed during the project development phase and budgeted for appropriately over the lifetime of

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<sup>6</sup> A. Cerbotari. October 2008. *Contingent Liabilities: Issues and Practice*. IMF Working Paper. Fiscal Affairs Department. [www.imf.org/external/pubs/ft/wp/2008/wp08245.pdf](http://www.imf.org/external/pubs/ft/wp/2008/wp08245.pdf) (accessed 5 January 2012).

the PPP projects. The report sets out roles and responsibilities, concepts, and processes based on international practices.<sup>7</sup>

The World Bank (2012) has also published the survey monograph, *Best Practices in Public–Private Partnerships Financing in Latin America: the Role of Guarantees*, which highlights the best practice for guarantees in Brazil, Chile, Colombia, Mexico, and Peru. The report emphasizes that the main purpose of guarantees is to facilitate the bankability of projects under a limited recourse project finance format secured by assets and cash flows by the project itself. The report covers the range of variations for “external support” from sponsors, main contractors, partial credit guarantees from government financial institutions, and monoline facilities to allow direct access to capital markets. The report also provides a description of the operation of guarantee funds in the five countries covered.<sup>8</sup>

#### 4. References on Philippine Public–Private Partnership Experiences

An early study of contingent liabilities in the Philippine BOT program is by Llanto (2005),<sup>9</sup> *Dealing with Contingent Liabilities: the Philippines*, which reviewed the evolution of contingent liabilities in BOTs. The study identified the types of project specific risks (e.g., performance risk, completion risk, market risk) in different sectors. It noted that the largest sources of risks were buyout clauses or termination events in the power sector, while toll changes in the adjustment formula were the largest risks for the transport sector. For the water sector, Llanto concluded that the largest risks could come from the need to assume the loans contracted by the concessionaire. Llanto estimated that the contingent liabilities of the Philippine government reached P1,671 billion or \$30 billion. This figure includes contingent liabilities on loan guarantees for government owned or controlled corporations (GOCCs) or government financial institutions (GFIs), guarantee institutions, PPP projects, and the buyouts of IPPs. The study noted there were some “attempts” to manage contingent liabilities under which the Department of Finance (DOF) is responsible for monitoring contingent liabilities working with two inter-agency committees of the National Economic and Development Authority (NEDA) Board: the Development Budget Coordination Committee (DBCC) and the Investment Coordination Committee (ICC).

Llanto proposed that a management framework should include correct pricing of guarantees, unbundling and assigning risks to the appropriate party, and providing guarantees only for core risks. The paper also proposed tracking guarantees through a system of programming and allocations, and proper accounting and budgeting.

The most recent major reference for managing contingent liabilities in the Philippines is the comprehensive study by Castalia Strategic Advisors undertaken for the Philippines–Australia Partnership for Economic Governance Reforms “to carry out the Reform Agenda 006-05: Strengthening the Management of Contingent Liabilities in BOT Projects.”<sup>10</sup> The comprehensive study included:

<sup>7</sup> R. Shendy, H. Martin, and P. Mousley. 2013. *An Operational Framework for Managing Fiscal Commitments from Public–Private Partnerships: The Case of Ghana*. Washington DC: World Bank.

<sup>8</sup> World Bank. 2012. *Best Practices in Public–Private Partnerships Financing in Latin America: the Role of Guarantees*.

<sup>9</sup> G. Llanto. 2005. *Dealing with Contingent Liabilities: The Philippines*. In NBER Fiscal Policy and Management in East Asia.

<sup>10</sup> Castalia Strategic Advisors. 2008. *Strengthening the Management of Contingent Liabilities in Build–Operate–Transfer (BOT) Projects*. Manila. Reports to Philippines–Australia Partnership for Economic Governance Reforms (PEGR) and Implementation Team.

- i. Activity 1: taking stock of existing contingent liabilities and systems for managing those liabilities, and recommending options for improving that management in the future;
- ii. Activity 2: developing the recommended contingent liability management system; and
- iii. Activity 3: training and capacity building.

The Castalia study also carried out a quantification of contingent liabilities based on contract provisions and applying stochastic analysis, and concluded that the level of contingent liabilities were not large or significant enough to justify a major assignment of administrative resources. Nonetheless, the study proposed procedures to monitor contingent liabilities and incorporate contingent liability criteria in project approvals. It analyzed alternatives for provisioning and funding contingent liabilities either through a standby facility or the creation of a contingent liability fund.

The Castalia chapter on the management of contingent liabilities was part of a bigger study which included an analysis and proposals for improving the risk management and BOT-PPP structuring process. It is not clear to what extent the government considered the detailed assessments and proposals of the Philippines–Australia Partnership for Economic Governance Reforms Castalia study, and why the proposals were largely not implemented.

The paper by Erik Woodhouse (2005), *The IPP Experience in the Philippines*, gives an analytical narrative of private investments in greenfield IPPs from 1988 to 2004, tracing the macroeconomic and political context against which the government launched the IPP program to address the power crisis which crippled the economy in the early 1990s, with the government taking on major contingent liabilities and assuming market demand and foreign exchange risks.<sup>11</sup> Woodhouse notes that the country chose not to renegotiate the power purchase agreements despite the large currency depreciations and economic recession from the Asian financial crisis which rendered the National Power Corporation (NPC) insolvent. The government eventually had to restructure the power sector under the Electric Power Industry Reform Act which transferred NPC's balance sheet to the Power Sector Asset and Liability Management Corporation that ended up absorbing and managing the contingent liabilities that materialized in the form of stranded costs and stranded debt.

There are at least three accounts of the “privatization” of the MWSS in 1997. The first one, published by the World Bank in 2000, is *The Manila Water Concession: A Key Government Official's Diary of the World's Largest Water Privatization* by Mark Dumol, the chief of staff of the secretary of Public Works and Highways who chaired the Board of Trustees of the MWSS when the two concessions for water supply distribution and sewerage services in the East and West Zones of the MWSS service area were awarded. The second, *A Tale of Two Concessionaires: A Natural Experiment in Water Privatization in Metro Manila* by Wu, X. and Malaluan, N (2006), continues the narrative by describing how the two concessionaires, Manila Water Company Inc. (MWCI) and the Maynilad Water Services Inc. (MWSI), had contrasting practices in corporate governance, financial management, and operations management which resulted in divergent outcomes.<sup>12</sup> Raul Fabella, former dean of the School of Economics of the University of the Philippines, wrote the third, *The Privatization of the MWSS: How and Why It*

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<sup>11</sup> E. Woodhouse. 2005. *The IPP Experience in the Philippines: The Program on Energy and Sustainable Development*. Stanford University Working Paper No. 37.

<sup>12</sup> X. Wu and N. Malaluan. 2008. A Tale of Two Concessionaires: A Natural Experiment in Water Privatization in Metro Manila. *Urban Studies*. vol. 45. no. 1 (January 2008). pp. 207–229.



*Was Won*, which is a case study of the “privatization” as a “singularly successful structural reform in the annals of Philippine political economy.”<sup>13</sup>

References for the fiscal costs from the contingent liabilities which materialized in the MRT-3 and the NAIA Terminal 3 project include the Castalia study and the book by Roel Landingin, *The Seven Deadly Deals*, which documents irregularities in major infrastructure projects in the 2001–2010 period.<sup>14</sup>

The other major reference for immediate antecedent issues in Philippine infrastructure is the monograph by the World Bank on “Philippines: Meeting Infrastructure Challenges” under the auspices of the World Bank’s underlying strategy for the Philippines “Supporting Islands of Good Governance.” The study was published in 2005 when the private sector’s participation in infrastructure development seemed to have “lost steam” or was mired in controversial projects. The World Bank observed that after the Asian financial crisis the unsolicited mode of project procurement was used for many major projects. There was also no strict compliance with the approval process and rules were not strict, thereby allowing unsolicited projects to be negotiated directly with the Office of the President and granted incentives; or terms of approval modified to a private proponent’s advantage. Many projects such as NAIA Terminal 3 or MRT-3 were controversial and the contingent liabilities crystallized in heavy fiscal burdens on the government. The World Bank also observed that the government was not able to prepare quality projects for solicited proposals consistent with the medium-term development plan.

## B. Problem Definition

A number of countries, including Australia, Colombia, Greece, Ireland, Portugal, South Africa, and the United Kingdom, have comprehensive frameworks for managing contingent liabilities in PPPs in the form of specific national PPP legislation or by accession to international legislation in the case of the European Union countries.<sup>15</sup> In Australia, guidelines set conditions under which the government can provide guarantees or incur contingent liabilities, including the requirement that risks are explicitly identified, and expected benefits outweigh the level and cost of risks. Guidelines requiring similar justifications for guarantees and contingent liabilities are followed in Canada. In Colombia, the framework for managing contingent liabilities is codified in a series of laws and decrees starting with the Ley 448 in 1998 which addressed the issue of provisioning for the contingent liabilities built up in the 1990s through the creation of a Contingent Liability Fund (a year after the law was passed the National Planning Department estimated that total contingent liabilities of the government—not limited to PPPs but including legal risks, natural disasters, pension liabilities, and others—had reached 154.11% of the gross domestic product (GDP)).<sup>16</sup> Subsequent contingent liability laws and decrees, such as Ley 819 in 2003, Ley 1150 in 2007, and Ley 1508 in 2012, defined conditions for budgetary responsibility and transparency, the definitions of contingent liabilities, disclosure requirements, and extensions of contracts, among others.

<sup>13</sup> R. Fabella. 2011. *The Privatization of the Metropolitan Waterworks and Sewerage System: How and Why It Was Won*. Built on Dreams, Grounded in Reality: Economic Policy Reform in the Philippines. Manila, Philippines: The Asia Foundation.

<sup>14</sup> R. Landingin. 2011. *The Seven Deadly Deals: Can Aquino Fix Arroyo’s Legacy of Costly and Messy Projects?* Manila, Philippines: Public Trust Media Group.

<sup>15</sup> Footnote 6, p. 8.

<sup>16</sup> Republica de Colombia Ministerio de Hacienda y Credito Publico. 2011. *Obligaciones Contingentes: La Experiencia Colombiana*. p. 10.

Specific to the Philippine situation, a formal framework for managing contingent liabilities will enable the government to make informed decisions to calibrate the amount of core and noncore risks to assume in PPP projects to strike a balance between minimizing exposure to fiscal costs on one hand, and offering an attractive risk–return proposition to ensure adequate investor response, competitive tension, and bankability. The framework will also enhance overall investor perceptions of country risk with a process to safeguard fiscal sustainability. The provisioning and funding component of the framework will also mitigate appropriations and liquidity risks for contingent liabilities that materialize.

The government’s position on the management of guarantees and contingent liabilities is found in different statements in existing laws and policy documents. As early as 1977, Presidential Decree 1177 on budgetary reforms stated that “the contingent liabilities of government shall be evaluated as part of the budget process, subject to such limits and guidelines as may be approved by the President”<sup>17</sup> and required that contingent liabilities should be included in the budget estimates of government entities and should be periodically reported to the secretary of finance and the budget commissioner. More recently, statements in the Philippine Development Plan, the Financial Reform Plan, and proposed revisions to the BOT Law express the government’s objectives and intent when it comes to the prudential level of contingent liabilities, which government agency is responsible for approving contingent liabilities in each project, disclosure, and provisioning.

In reality, the government’s policy on contingent liabilities is also reflected in the praxis implementing agencies and oversight agencies follow in terms of the analysis of contingent liabilities required from transaction advisers during project preparation, in the information required in the NEDA approval forms, and in the project teams’ actual decisions regarding the undertakings and contingent liabilities granted in the draft concession agreements for each project.

The Bureau of the Treasury (BTR) has also initiated a contingent liability monitoring process through an inter-agency technical working group that meets regularly to assess the developments of ongoing PPP projects and their contingent liability status.

At this stage, it would be appropriate for the government to formally adopt a framework for the management of contingent liabilities to be guided by a definitive statement of policy to be incorporated as a proposed amendment to the BOT Law. Establishing the contingent liability management framework as part of the law will also ensure institutional sustainability of contingent liability management policy.

It would also be advisable to flesh out the policy in terms of the following:

- i. What are the specific objectives of the policy?
- ii. What are the different modes of implementation for executing the policy?
- iii. Clarify the institutional roles and responsibilities, identify areas for reform.
- iv. Identify gaps in institutions, capacity, and processes which can be the subject of additional support.

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<sup>17</sup> Government of the Philippines. 1977. Presidential Decree 1177, Section 11.

## C. Objective

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The objective of this paper is to conceptualize the contingent liability management component in the next stage of reforms to strengthen the PPP process in the Philippines, with a focus on clarifying the issues and directions for the contingent liability management framework and identifying the gaps and areas for reforms and institution building as well a proposed road map of policy actions. The assessment will be cognizant of three underlying principles: (i) appropriate allocation of risk between the government and the private sector, (ii) adequate private sector response to infrastructure projects tendered for bidding, and (iii) management of fiscal costs and contingent liabilities to ensure fiscal sustainability.

## D. Methodology

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The paper starts with a review of the country's BOT program and PPP projects to highlight the outcomes and issues for contingent liabilities. Against the historical experience with contingent liabilities, existing policy statements and references to contingent liability management will be discussed, and a synthesis proposed of contingent liability management policy statement and specific policy objectives will be identified. The implementation modalities and requirements for each policy objective will then be articulated, and gaps between the implementation modalities and existing policies, processes, and institutions will be identified which will indicate the road map of action steps for reforms, capacity building, and institutional development.

## E. Report Structure

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The report will have the following parts:

- i. Review of past experiences with PPP contingent liabilities
- ii. Current institutional framework for PPP contingent liabilities
- iii. Objectives of contingent liability management policy.
- iv. Determining contingent liabilities at the project level
- v. Determining appropriate levels of contingent liabilities at the aggregate level
- vi. Project development and contingent liability approval process
- vii. Funding of contingent liabilities
- viii. Contingent liabilities disclosure and accounting issues
- ix. Recommendations to improve contingent liability management in the Philippines



# I

## REVIEW OF PAST EXPERIENCES WITH PUBLIC-PRIVATE PARTNERSHIP CONTINGENT LIABILITIES

### **A. Power Build-Operate-Transfer Projects**

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In the early 1990s, the Philippine economy was saddled with a crippling power crisis which was partly due to the decision by the administration of former President Corazon C. Aquino to mothball the controversial 600 megawatt (MW) Bataan nuclear power plant without replacing it with new alternative power plants. Another factor was the age and poor maintenance of power plants of the National Power Corporation (NPC), which were operating well below their nameplate capacities and were subject to frequent breakdowns. NPC, with its highly leveraged balance sheet and its administrative inefficiencies, was not in a position to undertake significant capital expenditures in new generation capacity. The government resorted to the build-operate-transfer (BOT) approach, enacting the first BOT law in Asia, to attract the private sector to invest in new power capacity.

The government had just concluded in 1992 the negotiations with bank creditors for restructuring commercial debt under the Brady deal as the definitive resolution to the country's external debt problem which began in 1984. The country was just getting back to limited voluntary access into international capital markets. Compared to its peer countries, external debt levels were quite high while international reserves were low. A narrow tax base resulted in large fiscal deficits. Nonperforming assets in the central bank's balance sheet hindered the execution of effective monetary policies. Inflation was high and volatile. A chronic balance of payments deficit made the currency prone to depreciation. The country was two to three notches below investment grade.

The country's precarious macroeconomic situation and the state of the power sector at that time made the government offer a strong support package to secure the participation of the independent power producers

(IPPs) in the BOT. The government absorbed demand risk and foreign exchange risk under the take-or-pay power purchase agreements with revenues denominated in dollars.<sup>18</sup> The BOT contracts also had fuel supply management agreements in which NPC assumed supply of feedstock risk. While under its charter debt obligations of the NPC are guaranteed by the national government, the bankability of the BOT projects was further enhanced by government guarantees on the obligations of NPC in the BOT contract through performance undertakings addressed to the private sector proponent and executed by the secretary of finance which confirmed that NPC's obligations had the full faith and credit of the government and that the republic's obligations were absolute, unconditional, and irrevocable.

Core risks are those which are standard government obligations on “fundamental rights” and/or which the government has full control. The government can influence the factors that make the project sensitive to such risks. Examples include the acquisition of rights-of-way in which the government can exercise its right of eminent domain. Noncore risks are those risks in which the government does not have full control but may have to absorb transitionally during a particular phase in the economic cycle. In the BOT IPPs of the 1990s, the government assumed such risks such as market demand, foreign exchange depreciation, and even equity returns that in a competitive market condition are normally classified as noncore risks. To the extent that macroeconomic policies affect economic growth, consumer incomes and purchasing power, and exchange rate volatility, such risks would have some “core” elements which are subject to the government macroeconomic policies, they had some element of core risks from the point of view of private investors. From the government's perspective at that time, the costs of assuming such noncore risks were offset by the wider costs of the economic recession and export competitiveness caused by the power crisis itself.

Except for performance risk of the operator should a power plant fail the periodic test for contracted capacity, the government's liabilities in take-or-pay contracts are mostly determinate and not contingent. The lease payments on the BOT projects during the cooperation period are also determined amounts and were recognized as capitalized lease obligations in NPC's accounts. There was, however, a significant contingent exposure of the government under these BOT contracts due to uncertainty mainly arising from the following:

- i. The total amount of contracted electricity will be fully dispatched and therefore NPC can recover the payments to the IPPs from tariff revenues.
- ii. The Energy Regulatory Board will allow tariffs to be adjusted fully for changes in the price of fuel and the exchange rate.
- iii. In the future, NPC may not have dollar assets to offset the impact of peso depreciation on dollar denominated capitalized BOT leases.

On paper, electricity end-users assumed exchange rate risk in the tariff rates as the NPC was provided automatic currency exchange rate adjustment in its charter. This was subject to the Energy Regulatory Board's approval and the approval process was typically subject to long delays. Tariff adjustments would also be capped

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<sup>18</sup> There was no power market at that time. The National Power Corporation was the single buyer from all IPPs. Under single buyer conditions, take-or-pay is the only feasible contract structure because the producer has no option to sell to anyone else. Hence, the government's full take of the demand risk. In the absence of a power market, the producer also has no way to hedge foreign exchange risks (in a competitive power market, as the exchange rate falls, market prices in national currency can be expected to rise since fuel has to be bid at world price). Hence, again, the single buyer market structure made the government take on the full exchange rate risk.

for political considerations, leaving the NPC to take on the shortfalls in disapproved rate increases. In effect, NPC was not able to pass on the full impact of exchange rate depreciations due to delays and shortfalls in the tariff adjustments granted by the Energy Regulatory Board. This handicap came to fore at the height of the Asian financial crisis with the impact of the peso devaluation on NPC's balance sheet, prompting the need to restructure the power sector and privatize NPC.<sup>19</sup> Such contingent costs would not be directly captured in the provisions in concession agreements. These can be considered as indirect contingent liabilities.

The BOT IPP programs drew adequate response from foreign private investors to help resolve the power crisis. By 1993, fast-track BOT power plants were able to close the demand–supply gap. This was followed by the construction of base load plants. From 1990 to 1997, the BOT program enabled the contracting of 8,224 MW of new power capacity at a total project cost of \$8.3 billion in private sector investments (Table 1). Overall, during 1990–2015, the BOT program enabled contracting of additional 26,500 MW of power capacity for a total investment cost of \$27.3 billion (Figure 1). Except during 1990–1997 when privatization of information and communication technology industry took place, the energy sector has been the largest recipient of private investment in infrastructure mainly through BOT scheme (Figure 2). Not surprisingly, this sector has so far been the major source of fiscal risk to the government, especially due to the impact of the 1997 Asian financial crisis.

**Table 1: Build–Operate–Transfer Power Projects**

	Investments (\$MM)	Capacity (MW)
1990–1997	8,299	8,224
1998–2009	9,953 <sup>a</sup>	12,441
2010–2015	9,093	5,812
<b>Total</b>	<b>27,345</b>	<b>26,477</b>

\$MM = millions of US dollars, MW = megawatts.

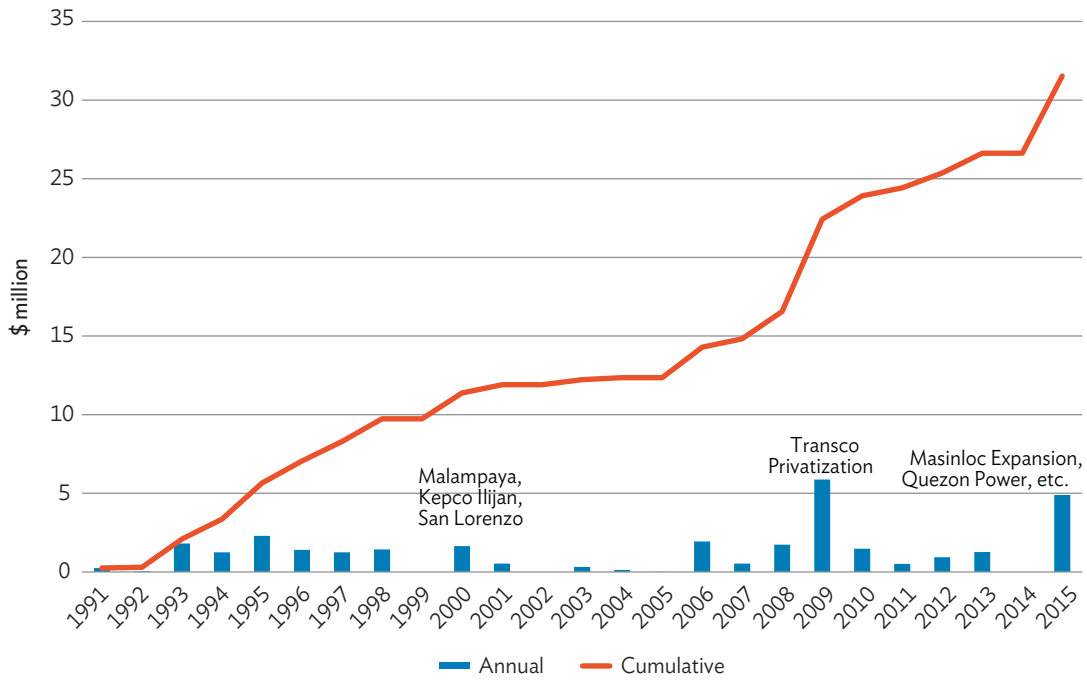
<sup>a</sup> excludes privatization of Transco of \$4,177 MM.

Source: World Bank Private Participation in Infrastructure Database.

The 1997 Asian financial crisis uncovered the extent of the government's contingent liabilities in the BOT IPP program and crystallized these into actual liabilities. The peso depreciated 46% from July 1997 to December 1998. By December 2001, the year the Electric Power Industry Reform Act was enacted, the peso–dollar rate reached P51.00 to a dollar, a 77% depreciation from July 1997. From 5.2% growth in 1997, GDP growth was -0.6% in December 1998 and -0.9% in January 1999. The peso depreciation rendered NPC insolvent and NPC consistently incurred negative profits from 1998 to 2003, starting at P3.6 billion in 1998 increasing to P12 billion in 2000 and P117 billion in 2003, representing a cumulative loss of 4.8% of GDP during the period. The recession and low growth in the extended recovery period made for weak electricity demand. From 1991 to 2000, IPP plants operated at only 36% of capacity versus the 85% plant factor contracted and paid for under the BOT concession agreements. Stranded costs (payments to IPPs not recovered from power sales) reached \$1.7 billion. Stranded debt (financing raised to cover NPC's deficits) reached \$6 billion which includes

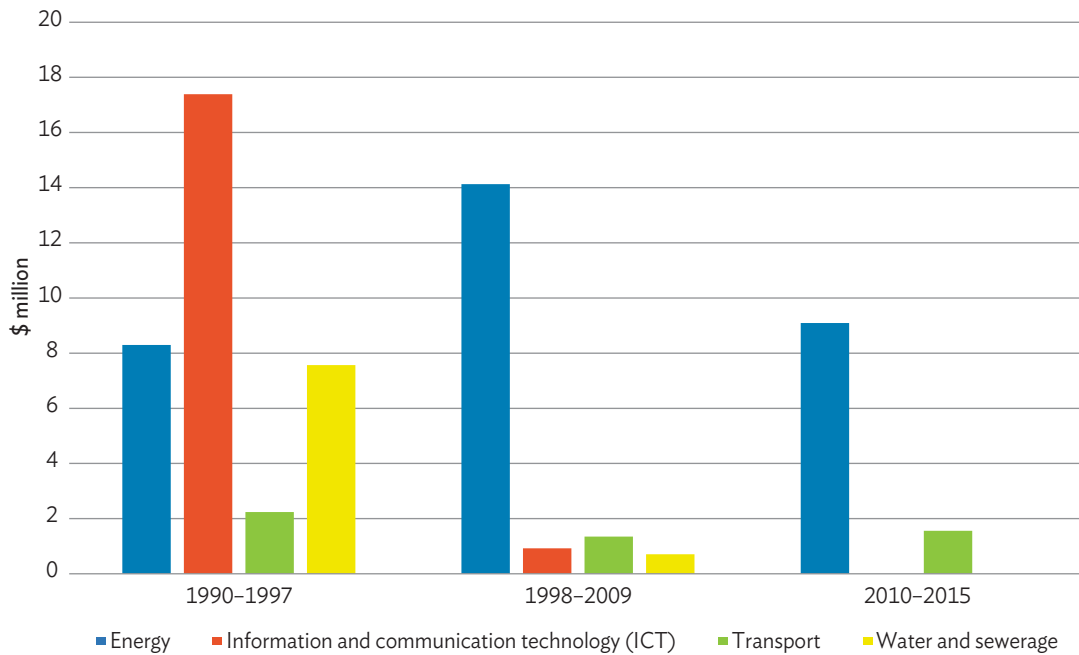
<sup>19</sup> In reviewing the contingent liabilities of IPPs, one needs to also consider the counterfactual, i.e., the NPC building and financing power plants on its own. It may be the case that the risks are the same under the IPPs and the counterfactual.

**Figure 1: Private Sector Participation in Energy Infrastructure, 1990-2015**



Source: World Bank Private Participation in Infrastructure Database.

**Figure 2: Private Sector Participation in Infrastructure, 1990-2015**



Source: World Bank Private Participation in Infrastructure Database.

the accumulated subsidies that consumers enjoyed when generation costs were not fully passed on to the electricity bill.

The story of the Philippine BOT IPPs highlights the large fiscal costs that resulted from the explicit and implicit, direct and indirect contingent liabilities, which materialized when the Asian financial crisis hit the country and the power industry. It also explains the reluctance of the government to (co)shoulder the noncore risks and provide guarantees or performance undertakings for PPP projects.<sup>20</sup> Even prior to the Asian financial crisis, the government was taking steps to ameliorate its exposure to direct and contingent commitments in the BOT program. In 1995, a consultative document which proposed to unbundle guarantees into core versus noncore risks, and transition out of noncore risks through fall-away provisions if the country's credit rating became investment grade, and/or to charge the private investors premiums for the guarantees required by investors. This approach was applied to the 1200 MW Kepco Ilijan power plant which achieved financial closure in 2000.

## **B. Metropolitan Waterworks and Sewerage System Concessions**

As in the case of the power sector, water distribution in Metro Manila, with a population of 11 million and 3 million connections, had critical problems in the mid-1990s: only 69% of the total service area had regular water delivery; availability of water was intermittent, averaging 16 hours a day. MWSS had a nonrevenue water rate of 56%, the highest in Asia, and double that of advanced countries. The International Finance Corporation was tapped to design the privatization strategy which recommended two 25-year concessions for the West Zone and East Zone of the metropolis. In 1997, under the National Water Crisis Law or Republic Act 8041, the MWSS entered into two concession agreements with a total project cost of \$7.478 billion, the largest water PPP in the world at that time. The West Zone concession was awarded to Manila Water led by the Ayala group while the East Zone was awarded to Maynilad Water Services of the Lopez group. The two concessions were awarded on the basis of extremely low bids for tariffs. The average base tariff in 1997 was P8.56 per cubic meter. The winning bids were P2.32 per cubic meter for Manila Water and P4.96 per cubic meter for Maynilad Water Services (Maynilad). The PPP engagement is governed by two separate concession agreements under which the concessionaries agreed to assume MWSS' outstanding debt of \$900 million, 90% of which was assumed by Maynilad, by way of paying concession fees to MWSS during the 25-year concession period. The concession agreement, which is covered by a performance undertaking from the Department of Finance, mandated expansion of network coverage in terms of the percentage of population served. The concession agreements provided for a guaranteed rate of return referred to as the Appropriate Discount Rate, a 5-year rebasing cycle to recover costs, quarterly foreign currency differential adjustment, annual adjustments to inflation, and provision for extraordinary price adjustment subject to MWSS approval.

Two external events adversely affected the concessions almost immediately after they were awarded. The El Niño weather cycle caused a drought in the Angat reservoir and a reduction of raw water supply by 40%, while the

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<sup>20</sup> Such approach may seem disputable if a more balanced view of the situation is done. Firstly, the risk allocation under power purchase agreements reflected the power market structure at that time, under which the allocation of the demand and foreign exchange risk to the government was the only available option. Secondly, efficiency was still achieved through transfer of performance risk to IPPs. Lastly, the counterfactual suggests two options: (i) no action by the government and fall into a crisis with all associated economic losses and sociopolitical consequences, and (ii) the cost of additional power generation would have been borne by the government anyway to avoid the options.



1997 Asian financial crisis caused the foreign debt of MWSS to nearly double in the first year of the concession period. The external events led to different outcomes for the two concessionaires. Maynilad went bankrupt and had to be terminated and re-privatized. Manila Water successfully handled the unfavorable developments and went on to attain improvements in nonrevenue water and service coverage, obtain financing from debt markets, and be publicly listed in the local stock market. Xu and Malaluan document how distinct differences in corporate governance, financial management, and operations led to different results for the two companies (footnote 12). Maynilad reportedly made heavy use of international consultants, sourced supplies from related parties without arms-length competitive bidding, did not assimilate existing MWSS employees into senior management, and sought to influence regulations and policies as is typical of utility monopolists. Manila Water, on the other hand, made minimal use of consultants and senior officials from the corporate group but promoted existing MWSS personnel and sent them abroad for training. It sourced supplies from third parties. Manila Water followed a decentralized corporate structure which empowered employees to resolve water leakages and repairs directly. Instead of borrowing abroad immediately which Maynilad did, Manila Water started with modest borrowings in the local peso market, leveraging on the business reputation of the Ayala group.

At the start of its concession, Maynilad had targeted a reduction in nonrevenue water from 64% in 1997 to 31% in 2001; instead, nonrevenue water rose to 69%, and, as a result, the volume of billed water was only half of the target level. Maynilad stopped paying its concession fee in April 2001, despite the numerous rate increases that had allowed it to recover foreign exchange rate losses due to the Asian financial crisis. The unpaid concession fees had accumulated to over P6.8 billion by the end of 2003, forcing MWSS to assume short-term loans to service its debts. In December 2002, Maynilad filed a notice of termination of its concession contract, blaming the government for the firm's difficulties in sustaining business in the West Zone and seeking reimbursement of more than \$303 million that the firm claimed to have invested. Bankruptcy was formally declared in November 2003, after the international arbitration panel ruled in favor of MWSS. Court documents show that Maynilad had accumulated unsecured liabilities of P17.4 billion against recoverable assets of only P2.4 billion. In 2005, Maynilad was turned over to MWSS under a so-called debt-for-equity exchange, in which Benpres Holdings Corporation (a member of the consortium that won the concession in 1997) relinquished its shares to MWSS and other creditors in exchange for unpaid concession fees and debts.<sup>21</sup>

Maynilad's overdue concession fees, which Maynilad intended to use to service its debt, reached P10 billion in 2004, forcing MWSS to incur more debt to avoid default from various sources, \$413 million from bank loans and P780 million from a bond issue.

From the point of view of contingent liabilities, the Maynilad problem can be viewed as a case of sponsor risk when the sponsor is not able to perform on its commitments and to cope with force majeure and adverse economic developments with Manila Water facing the same circumstances providing a counter example. The cost of the contingent liability to the government was to some extent mitigated by the \$120 million performance bond posted by Maynilad which MWSS was able to forfeit but only after a final ruling by the Supreme Court. The government would also be able to recover some of the costs from the proceeds of the reprivatization. The total direct and indirect costs most likely exceeded \$120 million.

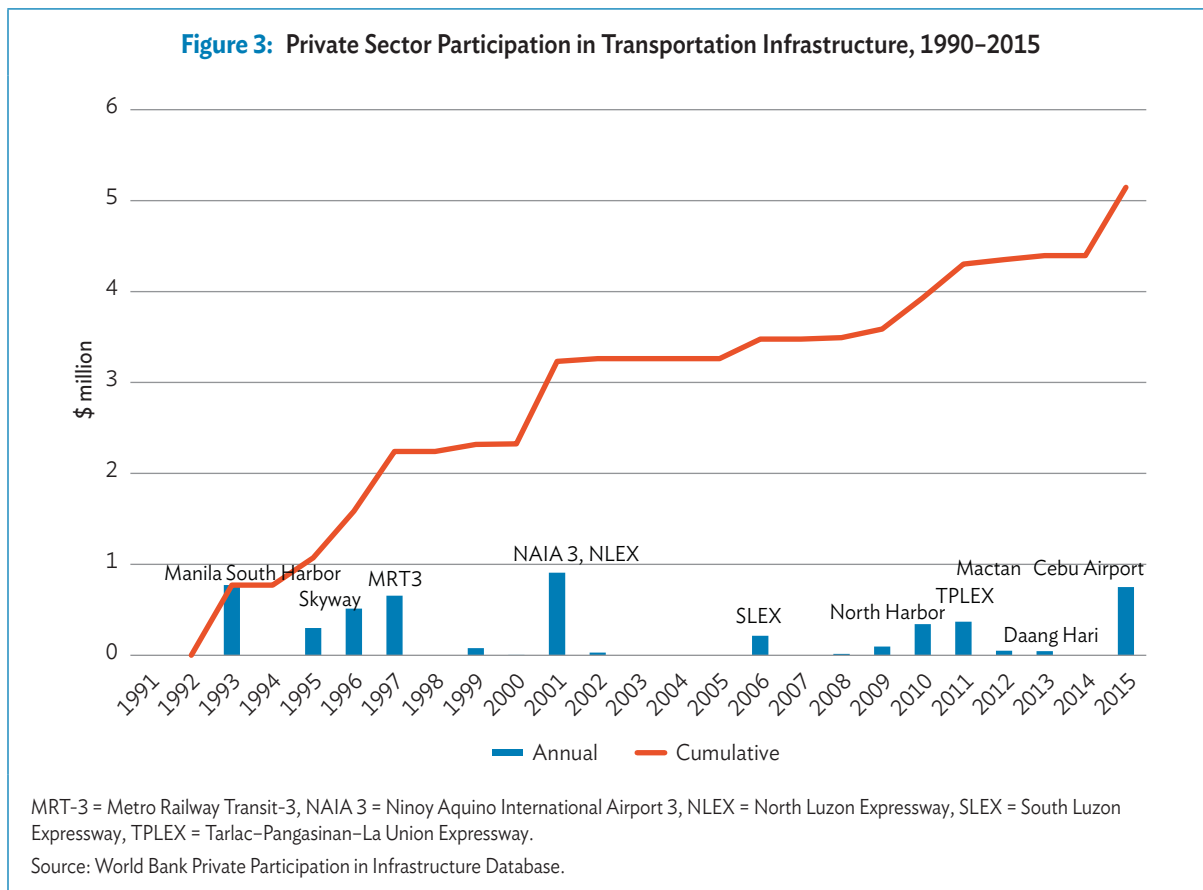
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<sup>21</sup> Footnote 13, p. 217.

From the point of view of managing contingent liabilities from sponsor risk, the lessons from Maynilad would include a more robust bid structure; avoiding the very low “bid to win” tariffs, which were lower than operating cost, meaning that borrowing had to be incurred just to cover operating expenses; and provisions on compliance with performance standards as well as the proper assignment of foreign exchange risks.<sup>22</sup>

### C. Transportation Public–Private Partnerships

The participation of the private sector as investors in transportation infrastructure has not been as extensive as in other sectors (Figure 3), with government undertaking many road and rail projects through Official Development Assistance. Many transportation PPPs were done during a “reactive” phase of the BOT/PPP program and were undertaken as unsolicited projects. Such projects were also the most controversial in terms of government support and incentives approved for the projects notwithstanding that they were unsolicited proposals with grossly disadvantageous terms to the government, engendering significant contingent liabilities which have materialized and which constitute major continuing fiscal burdens and represent problematic legal and policy situations that have yet to be resolved.



<sup>22</sup> It may be expedient to mainstream management of sponsor risk in the PPP legislation. In this respect, the current BOT Law seems to limit the government’s ability to manage sponsor risks: under this law the government is obligated to accept the lowest (tariff or viability gap funding [VGF]) or highest (payment to government) bid that passes technical evaluation—it cannot differentiate on a price-plus-quality basis.

MRT-3 actually started as a solicited project with the invitation to prequalify issued in 1991. Of the five companies that submitted prequalification documents, only one was deemed compliant. The Department of Transportation and Communication (DOTC) proceeded to negotiate with the one prequalified company despite legal challenges and urging from various sectors for the DOTC to re-tender the project. It took 6 years to develop the project in the course of which the project cost doubled from \$300 million to \$675.5 million by the time the build–lease–transfer agreement was signed in 1997. As pointed out by the Castalia study, MRT-3 was a case of (i) optimism bias (it took 10 years to achieve the original ridership targets), (ii) unbalanced risk allocation particularly in terms of the assumption by the government of ridership risk (guaranteed dollar equity returns, deficient due diligence by the government on the potential costs and risks), and (iii) political interference in setting fares at a minimum of P12.00 and maximum of P20.00 which was too much below the breakeven fare of around P65.00 needed to meet the equity rental payments.<sup>23</sup>

The structure of the project did not give the private proponent incentives to expand capacity or improve service. The Metro Rail Transit Corporation owns the project assets and leases them to the government which is obligated to pay lease fee consisting of a guaranteed return on equity and guaranteed debt service payments. DOTC is responsible for operations and maintenance.<sup>24</sup> The separation of construction and financing roles and risk from operations and maintenance did not require the private sector to recover capital costs from the operating revenues nor was it evaluated against service standards. The National Economic Development Authority (NEDA) determined that MRT-3 was not viable, but the government approved the project anyway.

The subsidized fare cost the government \$3.3 million a month in 2008 increasing to \$12.5 million a month during 2014–2024. The equity owner securitized the equity rental payments to private equity hedge funds which hampered the government's options for managing the project. In 2008, the government financial institutions, Land Bank of the Philippines and Development Bank of the Philippines, bought out the securitized bonds for an aggregate value of \$800 million.

The Castalia study highlights some of the key lessons from the MRT-3 project: (i) an uncompetitive procurement structure; (ii) failure to conduct an independent review of the project's financial assumptions and structure; (iii) the guaranteed equity return was a heavy burden for the government which may not have been as necessary to attract private investments to the project as a properly designed project would have; and (iv) lack of a well defined approval process which was open to legal challenges, resulting in significant delays. The Castalia study conducted an estimate of the contingent liabilities in the MRT-3 project based on the provisions in the concessionaire agreement for buyouts in the case of concessionaire default and other risks outside the government's control. The exercise resulted in net buyout cost of only P9.4 billion. The actual direct cost to the government of the project is a multiple of this estimate.

<sup>23</sup> The fares were initially set at higher levels, but it turned out that the willingness to pay was overestimated and the ridership levels were very low. So the decision to reduce fares could be seen as a rational response to the forecasting error: having built the system, it was not unreasonable for the government to conclude that the marginal benefit of getting more people off EDSA and on the rail was larger than the marginal cost of increasing the subsidy due to dropping the fare.

<sup>24</sup> It may be argued that the structure of the MRT-3 project was not really a PPP (there was no risk transfer at all), but a financial lease with the government essentially taking on full ownership risks.

The Ninoy Aquino International Airport Terminal 3 (NAIA 3) is another project in which the government incurred significant costs and contingent liabilities.<sup>25</sup> The project has been mired in complex controversies which can be traced to, among several factors, the lack of clarity in the process for approving unsolicited proposals and processing possible Swiss challenges to such proposals. NAIA 3 was originally proposed by a consortium of taipans who formed the Asia's Emerging Dragon Corporation but was trumped by a much higher bid from a smaller consortium of the People's Air Cargo and Warehouse Corporation, Security Bank, etc. Approval of the project did not go through the NEDA Investment Coordination Committee (ICC) but was reportedly decided at the level of the Office of the President. The project was awarded to Philippine Air Terminals Co. Inc. (Piatco) for submitting a high financial offer of P17.7 billion in concession fees to the government over 27 years versus Asia's Emerging Dragon Corporation's offer of P137 million. Over three presidential administrations, the project went through one controversy after another, ending with the administration of President Gloria Macapagal-Arroyo declaring the contract as null and void for granting incentives and provisions not in the original invitation to bid and for being grossly disadvantageous to the government. The foreign partner, Fraport AG in Germany, was also allegedly involved in an anti-dummy operation. The project has gone to international arbitration in Washington DC and Singapore and is unresolved as of this writing. Upon final resolution of the arbitration cases, the government needs to compensate Piatco for the expropriation of the project. Legal costs alone for the 3 years ending 2006 reached P1.1 billion. The NAIA 3 project is another example of the significant cost impact to the government of a poorly structured and executed project which goes beyond the nominal expected contingent liabilities that could be quantified from the project's concession agreement. This project, due to the government's revision of an existing contract and controversial judicial decisions, has been among the cases that have had a long lasting effect on the country's investment climate and caused apprehensions among the foreign infrastructure investors and lenders.<sup>26</sup>

In summary, while recourse to the PPP approach may have achieved certain objectives such as resolving the power and water crises, and decongesting (temporarily) urban traffic through private financing and construction of infrastructure facilities, these achievements came at substantial cost to the government. This is largely due to the uncompetitive market structure in certain sectors at the time, flawed bid parameters due to inadequate preparation and appraisal (e.g., awarding a concession where the tariff does not even cover operating costs sets the project up to fail even before it starts), and reliance on the unsolicited way of doing PPPs. Among the issues that stand out from the country's experience in the PPP approach in the last 30 years are (i) inadequate due diligence in assessing the cost to the government of noncore risks for extend concession periods; (ii) optimism bias in estimating demand and capacity requirements; (iii) failure to factor in sponsor risk in the selection of the private sector proponent; and (iv) lack of clarity and transparency in the approval process for guarantees, incentives, and terms and conditions in the concession agreements, including non-adherence to the established approval process in line with the BOT Law.

In 2005, the World Bank echoed these observations in its assessment of the issues that affected the private sector's participation in the Philippine infrastructure program:

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<sup>25</sup> The government also incurred significant legal costs arising from arbitration. The government also suffered from the foregone opportunity cost as it never received the promised concession fee for Terminal III plus the pace of roll-out of other PPP projects got affected resulting in the nonreceipt of concession fees from such projects.

<sup>26</sup> A. Haydarov. 2011. Philippines: Private Sector Development—Challenges and Possible Ways to Go. *ADB Southeast Asian Working Paper Series*. no. 5. Manila: Asian Development Bank (August 2011).

- i. poor cost recovery due to tariff adjustment delays resulting in financial losses;
- ii. corruption as a “top bottleneck” in doing business in the World Bank investment climate assessment;
- iii. absence of a more competitive framework citing open access in the power sector, while in the roads sector where the “lack of strong governance framework results in sub-optimal procurement practices and reduces the quality of road construction, which in turn reduces efficiency...;” and
- iv. low credibility of regulatory and judicial institutions.

The World Bank noted the decrease in private sector involvement in infrastructure, from a peak of 6% of GDP in 1998 down to 1% in 2002, primarily due to the “inability of the public sector to provide a suitable enabling framework that allows for easy private entry and exit, or the right incentives for operation.”<sup>27</sup> The World Bank identified the following specific factors:

- i. high general country risk;
- ii. deteriorating business environment for infrastructure;
- iii. weaknesses in planning, preparing, and executing private infrastructure projects;
- iv. unclear rationale and ineffective guidelines for providing fiscal support to private infrastructure; and
- v. ambiguous BOT policy and sector-specific gaps in the enabling framework.

The World Bank focused on the unsatisfactory situation in the BOT program at that time: “In addition, the vital element in the enabling framework—the landmark BOT Law of 1990—remains surrounded by controversies related to vagueness over unsolicited bids, where the scope for corruption becomes considerable. Indeed, most of the controversial infrastructure projects in the Philippines started as unsolicited proposals” (footnote 28).

Specifically, the World Bank noted the BOT Law and its implementing rules and regulations (IRRs) “(which) allows for unsolicited bids for BOT projects, has led to a number of scandals. Most of the controversial projects started as unsolicited proposals, notably the NAIA 3 and the Caliraya–Botocan–Kalayaan hydroelectric power BOT projects. The law’s IRRs require that all unsolicited proposals go through the ICC. However, the proponents of unsolicited proposals have bypassed the ICC, and instead, directly sought the approval of the Office of the President.” The vagueness of the law and IRRs at that time also allowed unsolicited proposals to obtain some form of indirect guarantees. There was also lack of clarity in the definition of government guarantees and the role of implementing agencies in contract revisions.

Among the World Bank recommendations to “reignite” private sector interest in infrastructure were the following:

- i. Attempt to reduce general country risk, particularly fiscal risk, as much as possible.
- ii. Strive to attract private investments on a transparent and competitive basis instead of through unsolicited bids.
- iii. Budget sufficient resources for preparing high quality pre-investment studies for projects that are likely to attract private investors.

<sup>27</sup> World Bank. 2005. *The Philippines: Meeting Infrastructure Challenges*. Infrastructure Sector Department, East Asia and Pacific Region.

- iv. Clarify the rationale for public support for private infrastructure projects, and identify and use appropriate instruments to meet development objectives, including the judicious use of guarantees for risks which the government is better able to control or manage which would reduce overall project costs.
- v. Require a central unit such as DOF to evaluate all guarantee applications.
- vi. Strengthen the enabling policy framework by improving the BOT Law and its IRRs.
- vii. Improve the public’s perceptions of private sector infrastructure providers.

## D. Current Situation

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The current situation can be considered as the third edition of the PPP program in which the administration of (former) President Benigno S. Aquino III seeks to learn from the costly outcomes of the previous PPP programs. A significant difference in the current situation is the much more favorable macroeconomic situation of the country after years of fiscal consolidation, sound monetary policies, and robust external policies. In recent years, the economy has achieved 6% to 7% sustainable real GDP growth, low and stable inflation, a structural current account surplus, record high international reserves, and ample domestic liquidity. Long-term and sizable project financing is now available from local banks. In 2013, the country achieved investor grade credit rating on the government’s external debt.

Under a more favorable country risk status, private investors in PPP programs would have fewer concerns about sovereign risk and macroeconomic prospects. The government would be in a better negotiating position with regards to having to assume “noncore” PPP risks. The approach of the Aquino administration is a preference for minimal government support whether in the form of performance undertakings, or assuming any market demand risk. Also, there seems to be a trend to temper projected equity returns.

The government has also given distinct emphasis on solicited projects in line with the government’s medium-term development plan, and there is a commitment of resources for building the institutional capacity to develop, bid out, and approve solicited projects. Specifically, the PPP Center was reorganized to assist implementing agencies in preparing solicited projects. A technical assistance grant for engaging international caliber transactions advisers was established in the Project Development and Monitoring Fund. The implementing agencies, together with the PPP Center, have identified a pipeline of over 50 projects including classrooms, hospitals, prison facilities, urban rail ticketing systems, airport terminals, toll roads, and gas pipelines.



# CURRENT INSTITUTIONAL FRAMEWORK FOR PUBLIC-PRIVATE PARTNERSHIP CONTINGENT LIABILITIES

## A. Definition and Types of Contingent Liabilities

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A contingent liability is a payment obligation whose occurrence, timing, and amount depend on some uncertain future event or circumstance. The usual explicit contingent liabilities of the national government include

- i. borrowing, lending, and/or guarantees by government owned and controlled corporations (GOCCs) and/or government financial institutions (GFIs);
- ii. obligations arising from PPP contracts;
- iii. unfunded pension liabilities of social security institutions;
- iv. damage and loss to government-owned infrastructure after disasters; and
- v. legal claims against the national government.

Implicit contingent liabilities of the national government pertain to noncontractual, political or moral obligations. Opportunity cost of non-intervention in case of materialization of implicit contingent liabilities can be unacceptably high, forcing the national government to step in even in the absence of a legal or contractual obligation. Examples of implicit contingent liabilities include:

- i. bailouts (“too big to fail”);
- ii. disaster relief (uninsured damage from natural disasters, compensation for terrorist attacks, transport catastrophes); and
- iii. environmental cleanup spending.

The Philippine experience has brought out another variant of PPP fiscal costs in the form of net losses from direct (not contingent) payments by the government, for which the contract revenue flows have not been fully realized. In the case of the build–operate–transfer (BOT) independent power producers (IPPs), National Power Corporation (NPC) take-or-pay capacity payments to the IPPs were not offset by revenues from electricity sales when demand fell short of installed capacity because of excess capacity and weak economic activity. With the adoption and implementation of the Electric Power Industry Reform Act of 2001, this does not seem to be a problem anymore as there is the possibility to sell electricity to more than one buyer, hence the demand risk is now absorbed by the IPPs. In the case of Metro Rail Transit-3 (MRT-3), Department of Transportation and Communication (DOTC) payments for guaranteed payments on farebox revenues and equity rental payments were not adequately offset from passenger tariffs, which were way below breakeven.

In the case of Maynilad Water Services (Maynilad), failure to pay concession fees required the Metropolitan Waterworks and Sewerage System (MWSS) to incur additional borrowings to refinance its own debts.

## B. Contingent Liability Management Policy as Stated in Government Documents

There is yet no single policy statement on the government’s policy for managing contingent liabilities as is the case in other countries. There are references to the government’s policy or policy intent in (i) the 2010–2016 Philippine Development Plan adopted by the Aquino administration; (ii) the Philippine Financial Management Reform road map adopted in January 2011 by lead agencies in the Government Integrated Financial Management Information System project, and (iii) in the draft amendments to the BOT Law.

The 2010–2016 Philippine Development Plan states the following:

**“Contingent Liability Management.** Considering the fiscal impact of realized contingent liabilities from existing BOT and GOCC projects that are guaranteed by the national government, a joint ICC-Development Budget Coordination Committee (DBCC) resolution will be issued to strengthen contingent liability management through the preparation of the Contingent Liability Management Plan by implementing agencies, training for value analysis and/or value engineering and contingent liability assessment, evaluation by the Department of Finance (DOF) of contingent liability for every financing/procurement option, and full disclosure of required budget for contingent liability that will become real liabilities and will thereby need funding.”<sup>28</sup>

The Philippine Financial Management Reform Road Map Toward Improved Accountability and Transparency, 2011–2015 which was crafted by the Government Integrated Financial Management Information System (GIFMIS) committee consisting of senior officials from the DOF, Department of Budget and Management (DBM), and Commission on Audit (COA) commits to a “Management of Contingent Liabilities Project,” a major component of the reform program. The contingent liabilities project specifically refers to the PPP program:

<sup>28</sup> NEDA. 2011. *Philippine Development Plan, 2010–2016*. Manila. Chapter 2. p. 57.



The government has an existing policy to promote public private partnerships in the delivery of public services to modernize and expand the capacity of infrastructure facilities. The new administration is also adopting this as a major strategy to achieve growth targets in some key sectors. This however exposes government to contingent liabilities that can turn into real liabilities that are absorbed by the national government.

The government sees the need to put in place a system for managing government’s exposure to contingent liabilities. Current efforts are focusing on determining the level of exposure by developing a policy on valuation and risk assessment and management. The task also involves the establishment of a database of GOCCs to facilitate a centralized monitoring and management of guaranteed loans. The immediate output would be a complete list of contingent liabilities which will be useful for policymakers to identify and address concerns about legal limitations on government action to define or delimit the scope of certain types of contingent liabilities. The project also envisions the formulation of an integrative framework that can be implemented through an executive policy order or legislation to authorize the appropriate agencies to take the necessary measures. For the medium-term, the project will get into comprehensively developing rules and regulations on

- i. setting accounting standards for full disclosure of contingent liabilities;
- ii. assigning the sole authority for issuing policies on contingent liabilities to the DOF;
- iii. clarifying and enforcing a consistent policy on when and how the National Government should assume liabilities incurred by GOCCs; and
- iv. reviewing charters of GOCCs and considering the need to propose a law to clarify and reiterate accountable and transparent incurrence of contingent liabilities.

The subcommittee for this project is led by DOF and COA officials.

The GIFMIS matrix of reforms (dated 13 January 2011) considered “Contingent Liabilities” as a crosscutting issue with the following gaps:

- i. The level of contingent liabilities inclusive of BOT is not known, or if known, is not reliable.
- ii. There is no regular monitoring of contingent liability arising from commitments entered into by GOCCs and local government units.

The GIFMIS committee identified the following short-term strategies or actions steps:

- i. Reissue COA accounting standards for contingent liability; full disclosure of contingent liabilities as notes to GOCC financial statements.
- ii. Study, and eventually graduate into a law, how DOF can act as the sole authority on the issuance of policy on contingent liabilities (for GOCCs and national government agencies) including the design of measures to control GOCC liabilities before they are incurred.
- iii. Study and develop a framework for managing contingent liabilities.
- iv. Define a policy on when and how the national government should assume GOCC liabilities without express guarantee.

- v. Set up a monitoring system.
- vi. Make regular monitoring and reporting of contingent liabilities a major function of the Debt Management Group, DOF-Bureau of Treasury.
- vii. Disclose in documents submitted to Congress all contingent liabilities.
- viii. Conduct regular audit of contingent accounts (by COA).
- ix. Integrate reports on guaranteed contingent liabilities for inclusion in the annual financial report of the government.
- x. Define clear-cut policy on issuance of external guarantees (including extended guarantees).
- xi. Coordinate with DBCC in the development of Contingent Liability Framework.
- xii. Develop database on contingent liabilities.

COA, DBM, DOF, and BTR were designated as lead agencies for action steps (i) to (ix) while the DOF was designated lead agency for steps (x) to (xii).

The “Desired Results” of the contingent liability management effort include

- i. an improved system for capturing and reporting all liabilities of government entities including guaranteed and contingent obligations, and
- ii. the national government is able to manage its financial exposure to contingent liabilities.

Contingent liabilities arising from PPP projects and their funding are also being considered for inclusion in the proposed revisions to the BOT Law. Specifically, the proposed bill on amendments to the BOT Law contains the following definition of contingent liability and provision on the contingent liability fund:

**“Contingent Liability.** This refers to obligations of the government arising from a valid PPP contract whose occurrence, timing, and amount depend on some uncertain future event or circumstance. Under an optimal allocation of risks between the implementing agency and the project proponent, each risk in a PPP project shall be assigned to the party that is best able to control the likelihood of its occurrence, manage its impact on the project, and absorb the risk at the lowest cost.”

**“SEC. 24. Funding of Contingent Liabilities Arising from PPP Projects.** To ensure fiscal sustainability, enhance ability of the implementing agency to discharge its obligations under risks allocated to it, and improve terms of financing of PPP projects, there is hereby created a Contingent Liabilities Fund which shall be financed through dedicated budgetary appropriations and contributions from the budgets of implementing agencies. It may also be sourced from bid premiums. The fund will provide a reliable pool from which disbursements on government obligations on liabilities that have materialized can be drawn. As such any appropriations and contributions to the fund are permanently appropriated and will not revert to the general fund if not disbursed during the life of the project. The fund shall be administered by the Department of Finance following fiduciary standards for fund management. The operations of the fund can be enhanced through Official Development Assistance.

As part of the budget submission, the Department of Finance shall submit an annual report on the status of this fund to Congress. Proceeds of the fund shall be invested in risk- free highly liquid assets. The governance structure, specific functions and responsibilities related to the operations of the said fund will be specified in the IRR of this Act.”<sup>29</sup>

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<sup>29</sup> Senate Bill “An Act Authorizing Public–Private Partnerships, Appropriating Funds Therefor, And For Other Purposes” S. No. 2665. Introduced by Senator Ferdinand R. Marcos, Jr. Accessible at <https://www.bongbongmarcos.com/wp-content/uploads/2015/02/SBN-2665-Public-Private-Partnership-PPP-Act.pdf>



## OBJECTIVES OF CONTINGENT LIABILITY MANAGEMENT POLICY

In his 2011 budget message to the 15th Congress, President Benigno Aquino III stated:

The responsible use of the public–private partnership (PPP) as a method of funding traditional public works and public services projects will reduce contingent liabilities of government. Providing funds under the Department of Transportation and Communication and Department of Public Works and Highways budgets as well as in the budget of the National Economic and Development Authority for undertaking feasibility studies on potential PPP projects will strengthen project development.<sup>30</sup>

The government may consider a broader set of policy objectives for contingent liability management beyond reducing the level of contingent liabilities. The policy objectives can be restated as “to maintain the level of contingent liabilities in the aggregate and in each project that is consistent with

- i. fiscal sustainability,
- ii. fiscal responsibility,
- iii. risk and/or return proposition that ensures adequate investor response and competitive tension and bankability, and
- iv. value for money.”

<sup>30</sup> President Aquino’s 2011 Budget message can be accessed at <http://diliman-diary-sidebars.blogspot.co.id/2010/08/president-aquinos-2011-budget-message.html>



# IV

## DETERMINING CONTINGENT LIABILITIES AT THE PROJECT LEVEL

The Philippine public-private partnership (PPP) experience showed that insufficient due diligence over the noncore risks retained by the government in the build-operate-transfer (BOT) independent power producers (IPPs), in Metro Rail Transit-3 (MRT-3), and the Ninoy Aquino International Airport (NAIA 3) resulted in large materialized costs most of which continue to burden the government.<sup>31</sup> The first line of defense against the adverse impact of contingent liabilities on fiscal sustainability would therefore be in the risk allocation at the project level and the consequent contingent liability retained by the government.

### A. Types of Government Support for Public-Private Partnership Projects

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The PPP Center’s policy brief on the “Government Share of PPP Project Costs and Risks” identifies the different types of government share or support for PPP projects, ranging from viability gap financing (VGF) in the form of capital grants, operating subsidies, guaranteed revenues, or take-or-pay provisions, performance undertakings by the national government, and contract provisions that mitigate project risks (Table 2).<sup>32</sup> Except for outright

<sup>31</sup> The definition of the noncore risks to be retained by the government depends in most cases on the objectives of the particular PPP project. For example, demand risk for a toll road in a heavily congested corridor may be noncore, but demand risk for a toll road designed to open up a new area and to shape urban form may be completely core—it is the risk the government is willing to take to achieve the developmental objective of the project.

<sup>32</sup> Accessible at <http://ppp.gov.ph/wp-content/uploads/2015/01/Government-Share-Incorporating-VGF-Final-Draft-asof-16Jan2013.pdf>

**Table 2: Government Support Instruments for Public-Private Partnerships**

OBJECTIVE/INSTRUMENT (at GPH level)	DIRECT COST <i>Can be budgeted although with some degree of uncertainty in some cases</i>	CONTINGENT or INDIRECT COST <i>Can be statistically valued but estimates are much less useful for budgeting</i>	PHILIPPINE CURRENT USE/IRR Reference
<b>Ensure Revenue Contractual Certainty</b>			
(a) Contractual Agreements or Performance Undertakings – Force Majeure			
• Relief and Compensation from Uninsured Natural Force Majeure	No	Yes	13.3b/e
• Compensation for Political Force Majeure	No	Yes	13.3b/e
(b) Other Contractual Agreements or Performance Undertakings to support			
• Take-or-Pay Arrangements	Yes	Yes	13.3b/e
• Leases, Capacity Payments	Yes	Yes	13.3b/e
• O & M Contracts	Yes	Yes	13.3b/e
• MYOA	Yes	No	Not a ‘real’ or legally binding assurance
<b>Lower Implementation Costs</b>			
(c) VGF – (Capital Investment Subsidies)	Yes	No	13.3a
(d) ROWA Provision	Yes	No, although final cost uncertain	13.3a/c
(e) Import Tax Waivers	Yes	No	Yes
(f) Security Assistance during Construction	Yes	No	13.3g
<b>Minimize Operating Uncertainties</b>			
(g) VGF, Other Operating Subsidies	Yes	No	13.3c
(h) Output Based Assistance	Yes	No	No
(i) Other Performance Undertaking	No	Yes	13.3b/e
• Formal Revenue Deficiency Guarantees	No	Yes	Regulatory action assurances
• Shadow Tolls	No	Yes	No
(j) Tax Holidays	Yes	No	Yes
<b>Mobilization of Capital</b>			
(k) “Hybrid” Projects including GFI Loans	No	Yes	13.3a
(l) Government Equity	Yes	No	Only if through GOCCs investing in PPPs
<b>Other</b>			
(m) Support of PPP Development through PDMF	Yes	No	Yes

GFI = government financial institution, GOCC = government owned and/or controlled corporation, GPH = Government of the Philippines, IRRs = Implementing Rules and Regulations, MYOA = multiyear obligational authority, O&M = operation and maintenance, PDMF = project development and monitoring facility, PPP = public-private partnership, ROWA = right-of-way acquisition, VGF = viability gap funding.

Source: GHD Pty Ltd. 2013. *Policy Brief: Government Share of PPP Project Costs and Risks*. Manila. This policy brief was developed for the Philippine PPP Center under Asian Development Bank’s Technical Assistance on Strengthening Public-Private Partnerships in the Philippines (TA7796-PHI). Accessible at <http://ppp.gov.ph/wp-content/uploads/2015/01/Government-Share-Incorporating-VGF-Final-Draft-asof-16Jan2013.pdf>

capital grants such as VGF or operating subsidies, many of the forms of government share or support, such as performance undertaking, translate to contingent liabilities of the government.<sup>33</sup>

Historically, the Philippine government first made use of the performance undertaking as a form of government support for the Hopewell Navotas power plant in the early 1990s, the second BOT project in Asia and the first in the Philippines to promote private sector participation in the power sector prior to the enactment of the BOT Law. When the government was asked to guarantee the obligations of the National Power Corporation (NPC) under the Navotas offtake contract, it was willing to support the financing in principle but was reluctant to extend to a private sector entity other provisions typically found in guarantee agreements for a direct guarantee of a GOCC. The Department of Finance (DOF) instead agreed to issue a performance undertaking that was for all intents and purposes a guarantee of NPC's obligations under the BOT contract but did not have events of default to which the government was sensitive because of possible cross-default provisions on its external debt. The DOF found a legal basis to support private sector projects in the charter of NPC, which authorized the government to guarantee NPC's loans and "indebtedness" on the basis of which the executive secretary rendered an opinion that NPC's payment obligations under the BOT/offtake contract constituted "indebtedness" which the Republic of the Philippines could guarantee. The performance undertaking was accepted by project lenders and was used for succeeding independent power producer BOT contracts in raising over \$5 billion in project financing.

Another form of government support in the Philippines is the provision of the right-of-way (ROW) for PPP projects. Provision of ROW is properly allocated to the government because it is in the best position to execute this role and absorb this risk given its right of eminent domain. The government can acquire the land or the ROW for project much faster as the private sector would typically first have to reach an agreement with the land and ROW owners, and pay compensation before being able to access the land for project purposes.

Risks normally thought to be the responsibility of the public sector, and hence become sources of contingent liabilities, are the following: (i) delays in permits and approvals; (ii) unavailability of site (land, right-of-way acquisition, resettlement); (iii) insufficient currency convertibility and limited profit repatriation; (iv) poor sponsor performance;<sup>34</sup> (v) discriminatory tax change; (vi) government initiated changes in output specifications; (vii) support network changes; (viii) changes in law or policy; (ix) problematic economic regulation; and (x) uninsurable force majeure events.

Occurrence of such risks leads to

- i. stream of payments (e.g., compensation for difference between contract and regulator approved tariff);
- ii. one-off payments (e.g., buyouts due to force majeure or government default, or termination payments due sponsor default); and
- iii. nonmonetary impact (e.g., extension of concession period).

<sup>33</sup> The essence of a performance undertaking is to provide a mantle of "full faith and credit" guarantee by the national government for the commitments and obligations of an implementing agency particularly, if the implementing agency is a government owned or controlled corporation (GOCC) with its own charter and board. If a performance undertaking translates into liquidated damages, then such performance undertaking can be a contingent liability.

<sup>34</sup> This can be mitigated through performance bonds and good project monitoring.

The more important “control” variable would be the possible requirement for the government to provide “noncore” support to make the risk and/or return proposition attractive to investors given their risk appetite at a particular phase of the business cycle and political evolution of the country, and/or to make the services of the project affordable to customers. This will entail direct costs in the form of viability gap funding in the case of user-based projects, or a stream of availability payments for social projects, and/or make active some form of contingent liabilities from some form of revenue guarantees which are sometimes found in PPP programs in other countries. It would be useful for the government at this juncture to clarify its posture on whether it is willing to consider such forms of support, under what paradigm and circumstances, and what mitigation measures and prudential limits it can put in place.

## B. Core Principles for Allocating Risks

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As mentioned above, guarantees and contingent liabilities should be the consequence of appropriate risk allocation to balance the need to transfer significant risks to the private sector while ensuring adequate competitive response. The general principle that risk should be allocated to the party in the best position to manage and bear it has been elaborated further by Irwin in terms of maximizing the risk valuation of a project by taking account of each party’s ability to

- i. influence the corresponding risk factor;
- ii. influence the sensitivity of total project value to the corresponding risk factor—for example, by anticipating or responding to the risk factor; and
- iii. absorb the risk.

Project risk can be understood as the variability of the value of the project to the three categories of stakeholders: project sponsor, customers, and government. Examples include the following:

- i. Construction risks are usually assigned to the project sponsor in a position to influence the final outcome in terms of on-time and fixed cost delivery through project management techniques.
- ii. Customers in user-fee projects are assigned general inflation risk as incorporated in tariff parametric formulas since inflation would be accompanied with wage adjustments. On the other hand, the government assumes regulatory risk tariff board approval of parametric tariff adjustment.
- iii. Demand risk can be viewed as under the control of the project sponsor to the extent that it can influence efficiency and quality of service for a given (affordable) tariff rate in which case is assigned to the private investor, as with most of the current user-fee PPP projects. However, this is not always the case. In many countries, PPPs include minimum revenue guarantees. In the 1990s IPPs, the government assumed demand risk in the form of take-or-pay provisions given the uncertainty of macroeconomic conditions. In MRT-3, the government assumed the risk in fare box revenues under the guaranteed 15% return on investment in dollar terms to the project company.

Irwin also presents a four-way categorization of risks between project-specific risks and economy-wide risks, and outcomes in terms of total project value and distributional effects across stakeholders (Table 3).



**Table 3: Four-Way Risk Categories and Examples**

Item	Total Project Value	Distributional Effects
Project-specific	Construction costs specific to the project	Regulated tariffs
Economy-wide	Construction wages	Exchange rate and foreign currency debt

Source: Irwin (2007).

Irwin points out that project-specific risks are typically under the control of one party and the emphasis should be on the first criterion of risk allocation, controlling the risk itself. The other two criteria of being able to influence the risk or to absorb the risk are not as important. In the case of economy-wide risks, most stakeholders are not able to influence the risk factor (or in the case of the government, it would be inappropriate to exceptionally manage the risk factor for a specific project). In this case, the second criterion—ability to influence the sensitivity of the project value and distributional implications of the risk—becomes a key consideration.

The allocation of risks is not static but changes with the evolution of the macroeconomy. This is also a function of the proven track record of the country. Risk aversion of investors changes as well, as can be observed in many countries. In Colombia, the government absorbed market demand risks in the initial phase of its PPP program. Later on, the government's level of support dropped. This was also true in Chile.

A reduction of the level of support was observed in the Philippines. After the initial success of the 1990s BOTs, the heavy fiscal costs of the guarantees prompted the government to modify the program for better management of contingent liabilities. In 1995, a consultative document proposed to unbundle risks into core and noncore risks, and proposed to lighten the government's responsibility for foreign exchange rate risk, for example, through fall-away provisions should the country achieve investment grade rating (Box). The consultative document also proposed to change fees for certain guarantees. It is significant to note that this took place prior to the 1997 Asian financial crisis which resulted in the large peso depreciation and dramatically increased the government's fiscal costs in the PPP program.

The new framework was applied to the remaining power IPPs, namely the San Pascual 300 MW cogeneration plant. In the Kepco Ilijan power plant, the level of government support was reduced such that the performance undertaking (PU) by the government was termed a partial performance undertaking (PPU).<sup>35</sup> In previous IPPs, the PUs gave blanket guarantees for various risks, whether payment or performance related (e.g., risks on energy fees, operations and maintenance supplemental payments, real estate taxes). In a PPU not all these risks were automatically guaranteed. Further, the guarantees for specific payments were defined narrower in a PPU. For example, the guarantees for availability payments covered only the extent required for debt service, and operations and maintenance, and excluded equity returns. The coverage for guaranteed buyout price and termination payments were likewise narrowed down in terms of triggering events, and costs, which excluded

<sup>35</sup> Woodhouse. 2005. *The IPP Experience in the Philippines: The Program on Energy and Sustainable Development*. Stanford University Working Paper No. 37.

**Box: Contingent Liability Management in the Philippines—Pre-Asian Financial Crisis Ideas****Management of contingent liabilities**

The Government of the Philippines responded to a critical national power shortage by providing “full faith and credit” guarantees to private sponsors against the risk of payment default the National Power corporation (NPC), the public power utility buying power on long-term power purchase contracts from private generators under a build–operate–transfer arrangement. The government waived its right to sovereign immunity, thereby accepting international arbitration in the event of dispute.

Provision of free guarantees was crucial to the financing of substantial generation capacity (about 3,000 megawatts), which alleviated the power crisis. But it meant that sponsors and lenders came to expect that such all-inclusive guarantees would always be available.

Recognizing that guarantees are neither desirable nor sustainable, the government issued a consultative document in March 1995, making specific recommendations for better management of its contingent liabilities (Government of the Philippines 1995). The government acknowledged that guarantees could not be eliminated abruptly and that a transition was required during which the legitimate risk mitigation needs of private parties would be met while an improving performance gradually allowed various elements of the guarantees to be eliminated.

A key feature of the policy was unbundling risk to allow more flexible management (table). Certain core guarantees of government obligations of “fundamental rights” under a project were seen as legitimate for the government to offer to establish a record of policy performance. Other guarantees, including the guarantee of currency convertibility and the risk of nonpayment of obligations by NPC, were seen as temporary and were also subject to higher fees.

The consultative document recommended withdrawing certain guarantees (such as the guarantee of currency convertibility if the Philippines attained investment grade credit rating and the guarantee of NPC payment obligations if NPC attained investment grade rating). It is also recommended limiting guarantees to 80% of total project costs in order to require equity investors to bear their share of project risks, developing model guarantee documents that would form part of the bidding package for prospective project sponsors, and instituting internal controls (including accounting for and reserving against guarantees).

A set of model guarantee documents was produced and is now being used in specific projects. The first project to which the approach was applied was the Renon Toll Road, which runs from Manila to Cavite. The key element guaranteed was the tariff formula. Since no guarantee was provided for traffic or revenue volumes, no payment obligation akin to the power purchase agreements was incurred by the government. The guarantee of foreign exchange convertibility provided only for equal treatment, as specified in current Philippine law. The new approach is also being applied to major power projects currently under negotiation, including the \$300 million San Pascual Cogeneration Facility. In all of these projects the government is using the new guarantee package to pare back its contingent liability and to provide a means for reducing liability even further when the need for a particular form of guarantee diminishes. Discussions are continuing with the sponsors. The policy is also being used for new water projects coming on stream.

*continued on next page* ►

**Box** *continued***Managing exposure under guarantees through unbundling risks**

Risk	Nature of Guarantee		Fee Charged <sup>a</sup>
	Core Guarantee	Noncore Guarantee	
<b>Sovereign Risks</b>			
Concession terms, expropriation, tariff formula, tax incentives	Terms define basic rules are largely under government control		None
Obtaining of licences, permits, right-of-way	Government commits to facilitating process. Risks not fully under central government control		25 basis points
<b>Foreign Exchange Risk</b>	Government assigns priority. Risk not fully under government control		25 basis points for the priority accorded
Convertibility of foreign exchange			
<b>Market Risk</b>		Not under government control	50 basis points initially to reflect commercial risk.
<b>Credit Risk</b>		Transitional need to make project financeable	No initial charge. Fall-away provisions when credit benchmarks are achieved.

<sup>a</sup> Fee charged is indicative only.

Source: Government of the Philippines. 1995.

equity. As an early implementation of the government's intention to charge fees for non-core guarantees, KEPCO subsequently paid the government \$800,000 annually to restore some of these guarantees.

The changes, conditions, and circumstances underlying the allocation of risks and provision of guarantees can be modeled using a framework from lossa. The framework explicitly models the relative risk aversion between the government and the private investor.

In the current context of strong economic fundamentals, so-called economy-wide risks may not be a binding constraint for investor interest. Together with the improved macroeconomy, the government also has a stronger fiscal position and can possibly afford to take a more accommodating posture in risk allocation for project-specific risks to spark investor interest and increase the number of bidders to promote competitive tension.

One positive development in recent biddings in the current PPP pipeline is the good number of potential investors who go to investor briefings and purchase the bid documents. However, in some projects, only a few bidders actually submit bids. The feedback in business chambers is that the PPP projects are not attractive in terms of the risk–return configuration.

The private sector is most concerned about policy risk. Per Irwin, policy risk is the unpredictable variation in value arising from unpredictable variation in government action, such as an unexpected change in rules governing controlled prices.

The current “hot issue” is MWSS’ order for its two concessionaires to roll back their tariffs instead of granting their petition for an upward adjustment. The principal cause of dispute is whether the income tax payments of the two companies can be recovered as an operating expense and even be paid the appropriate discount rate (or weighted average cost of capital). In line with the provisions of the concession agreement, both Manila Water and Maynilad filed dispute notices with the International Chamber of Commerce. The decisions of the appeals panels are awaited.<sup>36</sup>

Another issue is the real property tax charged to private investors by local government units. For example, it is unclear if and how the real property tax is to be applied to private sponsors under an operations and maintenance (O&M) or BOT contracts. This was the case with the PPP project of the Light Rail Transit Authority for the operation and extension of the light rail network in Manila. The lack of clarity has resulted in failed bidding of the light rail transit extension, prompting the national government to assume the real property tax risk which constitutes a contingent liability in that the local government can determine the tax applicable on the properties and the value of the properties.

There is also the Francisco case *obiter dictum* that the government has no authority to amend the Supplemental Toll Operations Agreement for the purpose of extending the operation period of a franchise, as a mode of compensating a concessionaire for shortfalls in tariff approvals, without Congressional approval.

The fundamental policy risk issue is that infrastructure investments are irreversible and expenditures are sunk costs. The private investor cannot dismantle the infrastructure facility and export it elsewhere or find an economical alternative use, i.e., the abandonment option has zero value. The government can allow enough revenues to cover operating costs such that the investor will not abandon the project and continue to earn even if it has incurred losses from the investment.

Allowing private investors sufficient equity returns can be balanced out with clawback provisions should revenues exceed baseline forecasts by a certain factor. The affordability issue can then be addressed through the VGF as the bid parameter as the government currently has fiscal space to pay for VGF and absorb direct costs. This will allow the government to avoid open-ended guarantees while ensuring investor response.

For social projects such as classrooms without user tariffs where the bid parameter would be the availability payments for given minimum project standards and specifications, the government may need to consider attractive equity internal rates of returns to draw meaningful investor responses.

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<sup>36</sup> In the Philippines, many concessions are bid out on the basis that tariffs are set by contract but to be effective upon approval of an independent regulator. In this case, a bid for a concession is essentially an estimate of the behavior of the future regulator. This may be less efficient and lead to distorted bidding.

Should there be a need to provide revenue support to attract higher investor responses, the government can charge a premium for the guarantee, apart from the clawback provisions discussed above.<sup>37</sup> An incentive for good decisions can include charges and fees on the beneficiary of the guarantees. The beneficiary could either be the project sponsor, lender, investor, or implementing agency. If the guarantee fee is included in the bid solicitation, bidders will price in the cost. The government can also require a revenue clawback for any upside revenues. The government can use markets to value the guarantees through risk insurers, reinsurers, or other financial institutions.

In any event, conditions for granting guarantees or absorbing noncore risks should include the following:

- i. There should be positive value-for-money in the project and the benefits of the guarantee should outweigh the costs.
- ii. There should be proper trade-off between controlling outcomes and providing guarantees. The government should be willing to bear risks on outcomes that it wants.
- iii. The government should avoid guaranteeing risks investors can manage. It is more appropriate to guarantee specific risks such as revenues, not returns. Otherwise, there will be no incentive to manage cost efficiency.
- iv. Partial risk guarantees on revenues should be preferred so the investor has a stake in revenue risk. A corollary guideline is to only pay for some losses and let the investor absorb some losses.
- v. Guarantees should be performance-based.
- vi. It would be more appropriate to guarantee debt not equity, but guard against high leverage. (In Kepco Ilijan, there was less coverage of equity in the termination payments in the concession agreement).

The other side of retaining some noncore risks to attract investors is sponsor risk. The absence of more competitive procurement and the small number of bidders has led to disadvantageous outcomes for government. There is also concentration risk if the same investor is awarded several projects.<sup>38</sup> From the point of view of lending institutions, limited recourse project finance structures, in which the project risks are secured by the project assets and cash flows, serve to demarcate sponsor risks. As brought forth by the outcomes in Maynilad Water Services (Maynilad) and NAIA 3, however, the government is exposed to the performance risk of the sponsor.

The first line of defense for sponsor risk is a stringent prequalification process and due diligence in verifying the credentials and qualifications of potential bidders. One screening can be the bracket ranking of the bidders' banking relationships and external auditors. Bidders can be required to make representations and warranties regarding their performance in the industry and any derogatory reports. Bidding rules can limit the number of projects that an investor can be awarded no matter how competitive the bids submitted. Stringent application of performance standards must be applied on investors that have been awarded several projects. The government can also require standby letters of credit on investors to shift the risk to financial institutions with a history of dealing with the investors. Greater use of performance bonds and quality- and price-based selection are good ways of mitigating sponsor risk.

<sup>37</sup> Charging guarantee fees for revenue support will depend on the nature of revenue risk. In most cases, the cost of the guarantee would be passed directly back into the bid, so there is no point in the charge.

<sup>38</sup> For example, from the 14 projects awarded since 2011, four were awarded to the same company that acted as lead or member of association of private sponsors.



# V

## DETERMINING THE APPROPRIATE QUANTUM OF CONTINGENT LIABILITIES AT AGGREGATE LEVEL

The public–private partnership (PPP) approach allows the government to overcome short-term budgetary and financing constraints by shifting the spending and borrowing to the private sector, and can be a method of “stealth financing.” Direct spending is replaced by contingent liabilities which can accumulate over time and threaten fiscal sustainability. These contingent liabilities need to be managed at the aggregate level, to be consistent with fiscal sustainability.

A contingent liability management framework that: (i) quantifies the contingent liabilities incurred in a consistent way across projects; (ii) sets prudential limits on contingent liabilities to ensure consistency with fiscal sustainability; (iii) monitors aggregate contingent liabilities; and (iv) submits to oversight authorities (Development Budget Coordination Committee [DBCC], PPP Governance Board, Congress) the status of contingent liabilities, gives the government more flexibility in committing support to PPP projects in the form of guarantees and/or contingent liabilities. With prudential limits, an annual budget for contingent liabilities can be allocated at the DBCC level.

In 2014, according to the Budget of Expenditures and Sources of Financing of DBM, there were 33 operational PPP projects with a total project cost of \$15.9 billion, and 17 pipeline PPP projects with the total estimated project cost of \$5 billion (Table 4). While the number of projects in the power sector is higher, the composition of types of projects has evolved toward more projects in the water, transport, and property development sector. Several studies on the total size of PPP contingent liabilities in the Philippines give a range of estimates. These are highlighted below.

Table 4: Build-Operate-Transfer Projects by Sector, 2001-2014

BESF	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014
<b>Operational</b>														
No. of projects														
Total	19.00	27.00	23.00	17.00	n.a.	40.00	45.00	44.00	37.00	n.a.	40.00	37.00	35.00	33.00
Power	8.00	10.00	5.00	4.00		26.00	22.00	20.00	17.00		15.00	15.00	11.00	11.00
Transport	6.00	6.00	7.00	5.00		3.00	6.00	5.00	4.00		5.00	5.00	7.00	5.00
Information technology	1.00	5.00	4.00	3.00		2.00	5.00	5.00	3.00		2.00	3.00	3.00	3.00
Water	2.00	2.00	2.00	0.00		4.00	4.00	5.00	5.00		4.00	5.00	5.00	5.00
Property development	2.00	4.00	5.00	4.00		4.00	7.00	6.00	5.00		7.00	8.00	8.00	8.00
Health	0.00	0.00	0.00	1.00		1.00	1.00	1.00	1.00		7.00	1.00	1.00	1.00
Other	0.00	0.00	0.00	0.00		0.00	0.00	2.00	2.00					
Environment		0.00	0.00	0.00		0.00	0.00							
Value (\$ millions)														
Total	13,483.80	5,491.90	5,011.27	2,765.38	n.a.	17,405.56	17,452.60	17,420.96	16,773.72	n.a.	16,312.92	16,377.92	15,859.06	15,859.06
Power	3606.00	4046.00	2306.00	1233.00		8415.86	7947.91	7,281.86	6,766.90		6316.90	6,316.86	5,229.00	5,229.00
Transport	2259.00	971.40	2291.90	1376.40		1205.00	1645.33	1,628.00	1,575.00		1628.00	1,628.00	2,190.00	2,190.00
Information technology	75.00	281.30	216.30	141.30		140.00	220.30	204.74	142.80		77.80	142.80	149.80	149.80
Water	7120.00	179.40	179.40	0.00		7189.40	7189.40	7,839.40	7,839.40		7839.40	7,839.40	7,839.40	7,839.40
Property development	423.80	13.80	17.68	13.68		454.30	448.66	50.960	33.70		449.90	449.86	449.86	449.86
Health	0.00	0.00	0.00	1.00		1.00	1.00	1.00	1.00		1.00	1.00	1.00	1.00
Other	0.00	0.00	0.00	0.00		0.00	0.00	415.00	415.00					
Environment		0.00	0.00	0.00		0.00	0.00							

continued next page

Table 4 continued

BESF Pipeline	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014
Number	39.00	35.00	17.00	25.00	n.a.	15.00	24.00	8.00	14.00	n.a.	11.00	10.00	21.00	17.00
Power	13.00	2.00	0.00	1.00	1.00	1.00	2.00	2.00	2.00	4.00	4.00			0.00
Transport	12.00	11.00	7.00	9.00	8.00	8.00	10.00	7.00	6.00			10.00		12.00
Information technology	3.00	4.00	4.00	5.00	3.00	3.00	4.00		1.00					0.00
Water	6.00	6.00	6.00	4.00	3.00	3.00	2.00	1.00	1.00	7.00				3.00
Property development	5.00	12.00	0.00	4.00	0.00	0.00	6.00		4.00					0.00
Health	0.00	0.00	0.00	2.00	0.00	0.00	0.00		0.00					2.00
Other	0.00	0.00	0.00	0.00	0.00	0.00	0.00		0.00					0.00
Environment	5.00	2.00	2.00	1.00	0.00	0.00	0.00		0.00					0.00
Education														1.00
Agriculture														3.00
Value (\$ millions)	6,054.65	4,610.17	3,566.78	4,157.59	n.a.	4,823.10	5,340.02	2,755.61	3,141.31	n.a.	388.11	6,496.20	4,903.98	4,976.65
Power	1487.90	469.60	0.00	6.40	3.57	3.57	403.60	392.70	392.70		376.73		0.00	
Transport	3930.00	3534.40	2715.37	3755.95		4565.78	4354.30	2,571.61	2294.70			6496.00	3254.73	3297.60
Information technology	30.00	62.00	63.11	11.85		43.36	175.70		0.00				0.00	
Water	580.00	297.80	671.30	242.52		210.39	134.00	184.00	184.00		11.38		1109.51	1109.50
Property development	9.55	128.80	0.00	116.35		0.00	272.50		270.00				0.00	
Health	0.00	0.00	0.00	24.42		0.00	0.00		0.00				139.60	139.60
Other	0.00	0.00	0.00	0.00		0.00	0.00		0.00				0.00	
Environment	17.20	117.60	117.00	0.10		0.00	0.00		0.00				0.00	
Education													239.05	239.05
Agriculture													161.09	190.90

BESF = Budget of expenditures and sources of financing, n.a. = not applicable.

Source: Philippines Department of Budget Management's Budget Expenditures and Sources of Financing for various years.



In 2001, Bernardo and Tang estimated indicative contingent liabilities at P1.41 trillion (36.2% of GDP) representing the present value of future payments by the government to BOT contractors and lenders, and explicit contingent liabilities at P455 billion (11.7% of GDP) representing the financial cost of buyouts or termination payments in BOT contracts.<sup>39</sup> The study covered 40 power projects, 6 transport projects, and 5 other projects (on water supply, housing, tourism, information technology, thermal coating, and printing plant). Llanto (2007) estimated that, as of 31 December 2003, contingent liabilities arising from guarantees provided for BOT projects stood at \$10.68 billion (13% of GDP) and contingent liabilities arising from buyout of IPP made up \$5.6 billion (6.8% of GDP).<sup>40</sup> ADB's technical assistance in 2007 estimated BOT contingent liabilities at \$20 billion (16.4% of GDP) in 2006.<sup>41</sup>

The conclusions of the Castalia study which performed a detailed analysis and quantification of major contingent liabilities in existing BOT projects (Table 5) are worth noting:

In particular, we have found that the Government's total exposure to contingent liabilities from BOT projects is *in fact relatively low*. The expected value of the payments by the National Government over the modeled projects' lifetime of P19.2 billion, and even the 2008 maximum cash exposure of P224.5 billion, are relatively small in comparison with, for example, the Government's current total debt stock of over four trillion pesos and annual expenditures of P1.1 trillion. As outlined [above] these liabilities represent only a limited sub-set of the Government's overall contingent

**Table 5: Values of Contingent Liabilities in Selected Build–Operate–Transfer Projects (P)**

Values of Contingent Liabilities in Modeled BOT Projects	2008 Gross Buyout Payment	2008 Net Buyout Payment	Lifetime Expected Value	Lifetime 90th Percentile Value
Ilijan power plant	32.4 billion	4.6 billion	9.1 billion	23.1 billion
Casecnan power plant	46.3 billion	23.1 billion	7.1 billion	12.2 billion
Caliraya–Botocan–Kalayaan power complex	18.5 billion	5.2 billion	1.1 billion	4.1 billion
Mindanao coal-fired power plant	12.8 billion	2.4 billion	1.2 billion	5.5 billion
San Roque power plant	31.1 billion	16.2 billion	856.9 million	1.9 billion
North Luzon expressway	9.3 billion	0	2 million	0
MRT-3 rail concession	34.1 billion	9.4 billion	271.3 million	0
MWSS (east) water concession	24.9 billion	0	0	0
MWSS (west) water concession	15.1 billion	0	0	0
Total	224.5 billion	61.0 billion	19.7 billion	40.5 billion

BOT = build–operate–transfer, MRT = Metro Rail Transit, MWSS = Metropolitan Waterworks and Sewerage System.

Source: Castalia Strategic Advisors. 2008. *Strengthening the Management of Contingent Liabilities in Build–Operate–Transfer (BOT) Projects*. Manila. Reports to Philippines–Australia Partnership for Economic Governance Reforms (PEGR) and Implementation Team., page 4.

<sup>39</sup> R. Bernardo and M. C. Tang. A Note on Philippine Government Contingent Liabilities. Unpublished paper.

<sup>40</sup> G. Llanto. 2007. *Dealing with Contingent Liabilities: The Philippines*. In NBER Fiscal Policy and Management in East Asia. NBER-EASE Volume 16.

<sup>41</sup> ADB. 2005. *Technical Assistance to the Philippines for Debt and Risk Management*. Manila (TA 4717-PHI).

liability exposure, other material sources of which include debt guarantees and pension liabilities. Nonetheless, our findings suggest that *a complex system for managing contingent liability exposure from BOT projects will not be cost-benefit justified.*<sup>42</sup> (Italics supplied).

The Castalia study used a framework identifying the contingent liabilities in the concession agreements in nine major projects in the power, urban rail, and water utility sectors. The study analyzed the risk drivers and the value at risk, and modeled losses using stochastic methods.

The study noted various factors to explain the relatively low level of aggregate contingent liabilities:

- i. The government managed to limit the amount of risk in the more recent BOT projects. In BOT toll roads, the government is generally not exposed to market risk. The government is in control of the risk that the Toll Regulatory Board will not approve the tariffs specified in the parametric formulas in the toll road concessions.
- ii. In the power sector which accounts for the majority of the government's exposure to contingent liabilities, the main source of contingent liabilities is the expected transfers to NPC to cover operating shortfalls, which, however, are mitigated in the case of power plants that are eligible for cost-recovery under the Universal Charge. The government may have to reimburse NPC/Power Sector Asset and Liability Management Corporation during those years these plants have cash shortfalls. The NPC/Power Sector Asset and Liability Management Corporation, however, may have other means to cover the shortfalls such as proceeds from privatization. The major risk to the government redounds to whether the Universal Charges are implemented or not.

Relating the information in the BESF project list with the projects modeled in the Castalia study, the following observations can be made:

- i. The nine projects in the Castalia study represent total project costs of \$11.54 billion, which is 70% of the total project costs in the BESF list.
- ii. Further, there are 12 projects mostly in the power and water utilities sector which the Castalia study identifies as being eligible for cost recovery through the Universal Charge, or which do not have performance undertakings. These projects represent \$3.94 trillion in total project costs, or 24% of the projects in the BESF list.
- iii. The remaining projects for which there are explicit guarantees, but which were not modeled in the Castalia study, represented total project costs of only \$690 million, or 4% of the BESF list.

In short, the contingent liabilities quantified in the Castalia study plus the projects which are eligible for Universal Charges or have no performance undertakings can account for 95% of total project costs. While the above observations should be confirmed further, it seems reasonable to accept that the estimated contingent liabilities in the Castalia study cover the major portion of the government's contingent liabilities, and the Castalia conclusion that the government's exposure to contingent liabilities from legacy projects is relatively low.

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<sup>42</sup> Footnote 10, p. 58.

Other countries set prudential limits on their contingent liabilities in various ways (see Table 6).

**Table 6: Prudential Ceilings on Contingent Liabilities**

Europe	
United Kingdom	Departmental Spending Limits ranging from 6% to 7% of total annual spending. <ul style="list-style-type: none"> <li>– Sustainable investment rule: public sector net debt as a proportion of GDP will be held over the economic cycle at a stable and prudent level. Other things being equal, net debt will be maintained below 40% of GDP over the economic cycle.</li> <li>– Annual payments under Private Finance Initiative unitary charges make up a very small proportion—under 2%—of departments’ total annual resource budgets.</li> </ul>
Greece	Current payments of approved PPP projects account for 6%–7% of its Public Investments Program, expected to reach 10%–12% in 5 years, ultimately capped at a limit of 15%.
Hungary	Total nominal value of multiyear commitments in PPPs should not exceed 3% of government revenues.
Latin America	
Brazil	PPP law prohibits undertaking new PPPs if the projected stream of payments under the overall PPP program exceeds 1% of government revenue in any future year. <ul style="list-style-type: none"> <li>– Overall expenditure annual limit with PPP of 1% of the government net current revenues in the fiscal year that the contract will be signed and in the 10 next years (PPP Law).</li> </ul>
Peru	Present value of total commitments to PPPs (firm commitments plus measurable contingent liabilities) must not exceed 7% of GDP
Asia	
India	Inter-Ministerial Task Force in September 2010 report proposed that the sum of total annuity commitments for a particular grant or scheme of any ministries, departments, and agencies (MDA) for the next 5 years should not exceed 25% of the department’s current Five Year Plan outlay of such grant or scheme. However, no cap is set for guarantees issued to PPPs.
Republic of Korea	<ul style="list-style-type: none"> <li>– Setting up a PPP payment allowance rule or ceiling as a fraction of total budget has recently been discussed. The government may effectively manage the expected payment for signed PPP contracts under the Medium-Term Expenditure Framework.</li> <li>– Following the United Kingdom practice, the total annual government payment on PPP projects should be less than 2% of the total government expenditure.</li> <li>– The current forecast on PPP projects suggests that the figure will reach up to 1.9%.</li> </ul>

GDP = gross domestic product, PPP = public–private partnership.

Source: World Bank Group. 2014. *Operational Note: Implementing a Framework for Managing Fiscal Commitments from Public-Private Partnerships*. Washington DC; Katja Funke, Tim Irwin, Isabel Rial. 2013. *Budgeting and Reporting for Public-Private Partnerships*. IMF, International Transport Forum. Discussion paper no. 2013–7.

To implement the tracking and management of aggregate contingent liabilities, a necessary precondition is building the capacity for quantifying contingent liabilities with a consistent analytical methodology. While there have been one-off exercises conducted over the years, it is important to institutionalize the process in terms of making the analysis and quantification part of the project development activities and project approval process. There also needs to be a central unit that conducts the quantitative analysis using a consistent methodology, and central data base for quantification results. The central database will facilitate aggregate monitoring, report preparation for Fiscal Risk Statements and other forms of disclosure, and can also be useful for the government in negotiating terms and conditions in concession agreements. Such capacity can be located in the Debt and Risk Management Office (DRMO) in the Bureau of the Treasury of the Department of Finance, which can provide

staff support to the Corporate Affairs Group (CAG) and the implementing agencies in evaluating contingent liabilities during project development.

Many countries have established practices in quantifying the cost of contingent liabilities following common approaches.

The *scenario-based* approach relies on expert judgment on “worst case” outcomes of variables affecting contingent liability value and the consistent combination of outcomes that are built up to constitute a scenario. This approach is frequently used by governments as a practical way to analyze risk. It gives the range of possible outcomes, but not their likelihoods.

*Probability-based* approaches assume an underlying stochastic process in the distribution of possible outcomes on key variables which affect contingent liability. Assumptions are made on the appropriate probability distribution function and the values of the parameters for a given distribution function. This enables the estimation of distribution of possible costs and calculation of median (most likely) cost, mean (average) cost, and the Cost at Risk at a given percentile. This approach substitutes stochastic simulations for expert opinions but is sensitive to the choice of the probability distribution function and the values for the input parameters.

The measurement of contingent liability costs also needs to differentiate between one-off contingent liabilities such as buyouts and termination payments, and stream type of contingent liabilities. Both can be calculated based on discrete assumptions (scenario-based approach) or expected values derived from probability distributions (probability-based approach) of underlying risk variables.

For one-off contingent liabilities, the gross cost would be the face value of payment amount upon realization of contingent liability as per PPP contract or guarantee while the net cost would subtract from: the gross cost the recoverable value of asset gained.

For stream-type contingent liabilities, the cost would be based on the present value of contingent liability payment stream, or the annual contingent liability values during the contract period. Tariff shortfalls due to failure to approve tariff adjustments according to the parametric formula would be based on the present value of (i) projected inflation rate (or relevant benchmark in the tariff formula) and (ii) a scenario-based or probabilistic analysis based assessment of the quantum and the frequency of the shortfall.



# VI

## PROJECT DEVELOPMENT AND CONTINGENT LIABILITY APPROVAL PROCESS

In addition to having an appropriate framework of allocating risk and deciding on the merits of providing a guarantee, Irwin emphasized the importance of having rules in place to promote a proper consideration of the benefits versus the cost of the guarantee and appropriate fiscal management. The purpose of rules is to make sure that the government makes good decisions when it comes to giving guarantees. Good decisions are driven by moral imperative (the opposite of moral hazard) and characterized by responsibility, prudence, and stewardship.

Implementing agencies can be too focused on getting the project implemented and not be too mindful of the overall fiscal costs of the guarantees. They may also have the incentive to hide subsidies as contingent liabilities, since that does not come out of their budget. It is appropriate that the Department of Finance with its broad responsibilities for fiscal sustainability be involved in the approval of guarantees at the level of each project and at the aggregate portfolio level. There is merit as well in having guarantees approved collectively at the cabinet level.

The institutional framework includes

- i. role of oversight committees in approving guarantees that encourage decision makers to internalize the costs and benefits of guarantees,
- ii. formal criteria required for guarantees as may be embodied in a policy statement,
- iii. central unit responsible for quantifying the costs and benefits of guarantees and contingent liabilities,
- iv. disclosure standards,

- v. modern accrual accounting to promote fiscal discipline, and
- vi. provisioning and budgeting for guarantees.

## A. Project Approval Process in Other Countries

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In many countries, parliamentary approvals are required for loan guarantees and other contingent liabilities. According to Cerbotari: “About half of the Organisation for Economic Co-operation and Development (OECD) countries require parliamentary approval of loan guarantees (including Belgium, Canada, Denmark, Finland, France, Germany, Greece, Iceland, Italy, Poland, Spain, Sweden, the United Kingdom, and the United States) and about a third require parliamentary approval of PPPs (including Denmark, Iceland, Italy, Mexico, Norway, Poland, Sweden, Turkey, and the United Kingdom) (Lienert and Jung 2004; OECD 2007). Other countries where parliamentary approval of various contingent liabilities is required include Brazil, Chile, Colombia, Mexico, Peru, and the Russian Federation. Generally, the requirement for parliamentary approval of loan guarantees is included in ordinary laws (budget system laws or specific debt or borrowing laws), although in Finland and Germany this requirement is written in the Constitution (Lienert and Jung 2004). In Sweden, the State Budget Act allows the government to issue guarantees for purposes and amounts that are approved by Parliament. In some countries, the authority to approve contingent debts rests with the Ministry of Finance (e.g., South Africa, although the public entities that issue guarantees are required to report to Parliament on the circumstances related to any payment on the guarantees) (footnote 6).”

In Chile, the Ministry of Public Works (MPW) takes the lead in designing, awarding, and monitoring concessions. But the Ministry of Finance (MOF) must approve the concession contract and other bidding documents. According to Irwin and Mokdad, the MOF requires the MPW to list the risks created by the concession (footnote 5). The MPW is also required to get approval from the Ministry of Planning for the analysis of the project’s economic and social benefits. The MOF must approve any circular that clarify or modify economic aspects of the bidding documents. The MOF must be represented in the selection committee that evaluates the bids. The supreme decree issued by the MPW to formalize the concession must also be signed by the MOF together with the comptroller, auditor-general, and the President. The role of the MOF continues after the concession has been awarded. The MOF also needs to approve any change in the concession agreement and any agreement to resolve disputes. Through its contract monitoring activities, the MPW plays a key role in mitigating risks where possible and in providing early warnings of contingent liabilities possibly materializing.

In South Africa, national and provincial PPPs need to get the approval of the National Treasury in four stages. Treasury Approval I must be obtained before procurement begins. Based on a feasibility study, it should be shown that the proposed PPP is in the best interests of the contracting agency, and that the agency has the capacity to enter into and manage the proposed PPP. Treasury Approval IIA must be obtained before bidding documents, including the draft PPP contract, can be issued. Treasury Approval IIB must be obtained before appointing a preferred bidder. Treasury Approval III must be obtained before the contract is signed.

The State of Victoria in Australia has well-defined procedures for developing and approving PPPs. Approval of the cabinet or one of its committees is required at four critical stages: obtaining funding and project approval, before issuing the expression-of-interest invitation, before issuing the project brief, and approval of

the contract management plan. In 2001, Victoria was the first state to publish PPP guidelines that included a detailed discussion of risk allocation and contractual issues. In 2008, national guidelines (partially based on Victoria's guidelines) were issued. The guidelines describe the process for governments to follow in developing and awarding PPP contracts, as well as the risks that they should generally assume and those that they should not. The guidelines help to control the contingent liabilities in PPPs.

## **B. Central Contingent Liability Management Unit in Other Countries**

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In many countries, a central contingent liability management unit supports the contingent liability approval process.

The Ministry of Finance of Chile has a Contingent Liabilities and Concessions Unit with three members as of 2010 (footnote 5). It was established in 2006 as part of the Budget Department. Although it has considerable expertise in concessions, the unit is responsible for monitoring a wide range of contingent liabilities, not just those associated with concessions. The government's main source of expertise on concessions is the much larger Concessions Department in the Ministry of Public Works.

The South Africa National Treasury has a 22-man PPP unit which leads the four-stage review and approval process for PPPs. The PPP unit has developed a PPP manual and set of standard provisions for PPP contracts to guide contracting agencies. According to Irwin and Mokdad, Module 5 of the PPP manual "suggests that the application for Treasury Approval III include a section on contingent liabilities (footnote 5)." The standardized PPP contract provisions include those that should govern early contract termination and associated compensation payments. Through these mechanisms, the PPP unit in the National Treasury seeks to control the contingent liabilities that the government incurs in PPPs. In addition, liabilities associated with large PPPs are reviewed by the Fiscal Liability Committee during the Treasury Approval III stage. The PPP unit is the key advisor to other government agencies regarding PPPs but the control function is shared with other parts of the National Treasury such as the Asset and Liability Management Group that have a broader view of the government's financial position.

A PPP unit in the Department of Treasury and Finance helps it provide advice to the cabinet during the PPP approval process. According to Ian Hawkesworth, the unit has 12 staff members.<sup>43</sup>

## **C. Project Approval Process in the Philippines**

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In the Philippines, the final approval for major capital projects rests with the NEDA Board chaired by the President of the Philippines. Prior to consideration by the NEDA Board, however, the project has to be cleared by the NEDA Investment Coordinating Committee (ICC). The ICC is tasked with advising the President on a broad perspective of the impact of major projects on the economy and the government's economic programs.

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<sup>43</sup> I. Hawkesworth. March 2009. *Dedicated PPP Units*. Presented at the 2nd Annual OECD Meeting on PPPs, Paris, France.

The NEDA ICC consists of an ICC Cabinet Committee (ICC-CC or “Cabcom”) which vets the projects prior to formal consideration by the ICC Technical Board. The Cabcom is chaired by the secretary of finance, which indicates the primacy given to the fiscal perspective in the deliberations and assessment of major infrastructure projects.

The formal approval criteria currently applied by the government for infrastructure projects reflect the country’s historical economic situation of limited foreign exchange reserves and fiscal constraints. This also reflects the orientation of government procurement of infrastructure projects and the need to manage government resources judiciously. Thus the NEDA criteria emphasize the fiscal, monetary, and balance of payments implications of major capital projects. The NEDA Board recommends to the President the timetable of the implementation of these projects on a regular basis, taking into account the following:

- i. peso requirements of the project in terms of the current and capital outlays needing peso support directly or indirectly from the national government and/or government financial institutions;
- ii. foreign exchange requirements of the project in terms of the current and capital outlays needing foreign exchange directly or indirectly from bilateral and/or multilateral sources;
- iii. sources of funds;
- iv. terms and conditions of the proposed financing; and
- v. where applicable, compliance with foreign debt ceiling under Republic Act 4860, as amended, per certification of the Bureau of Treasury.

The historical focus of the approval criteria may not be exactly relevant in the context of the current economic situation and for PPP situations. For one, the country does not face severe foreign exchange constraints as before and has adequate access to international capital markets. The country also has access to Official Development Assistance sources and economic managers are assessing the relative advantages of Official Development Assistance financing. The government also needs to ramp up the infrastructure program so it might be appropriate to focus also on quick execution.

In the case of PPP projects, the financing of infrastructure projects is shifted to the private sector. The relevant “scarce resource” that government needs to focus on is the risks retained by the government in the overall risk allocation in PPP projects and the contingent liabilities incurred in each project and at the aggregate level. While concerns on retained risks and contingent liabilities may be the focus of economic managers in NEDA Board deliberations, it would be appropriate to adopt more formally in the case of PPP projects being evaluated.

Significantly, the NEDA ICC Technical Board is chaired by the NEDA senior representative, and the co-chair is a senior representative of the Department of Finance International Finance Group. A senior representative of the DOF Corporate Affairs Group (CAG) is a member. The deliberation on the contingent liabilities in each project is formally part of the information submitted to the ICC on the project structure which includes the proposed risk allocation, the government’s exposure in terms of right-of-way (ROW), direct expenditures which can be in the form of VGF, and contingent liabilities.

The basic document submitted to the ICC is the ICC Project Evaluation Form. In the April 2015 project evaluation forms for PPP projects, the two forms related to contingent liabilities of PPPs are the forms number



5 and 8. Form number 5 describes the risks and their allocation between the government and the private sector. Form number 8 shows the maximum government exposure arising from the proposed government undertaking (through right-of-way acquisition, resettlement, tariff subsidy, national and local taxes, duties and charges, and government-supported enhancements) and contingent liabilities.<sup>44</sup> It is not clear to what extent the information by the NEDA Board to evaluate retained risks and quantified contingent liabilities is provided in sufficient detail for a full assessment discussion of the concerns and issues for PPP projects.

Revisions to the PPP project appraisal process currently being promulgated by the PPP Governing Board.<sup>45</sup> Under the new guidelines, the assessment of the project will be compartmentalized into four major areas and assigned to specific agencies as follows, with the Department of Finance taking the lead in the assessment of contingent liabilities and fiscal risk arising from PPPs:

- i. **NEDA Secretariat.** The agency shall appraise each PPP project in terms of its alignment and contribution to the Philippine Development Plan. In so doing, NEDA Secretariat will undertake the assessment of the socioeconomic aspects of the project through a cost-benefit analysis and/or other methods deemed necessary, including ensuring compliance with existing laws, rules and regulations (e.g., social, environmental, local appraisal policies, etc.). In the exercise of due diligence, it shall also look at the financial data needed for the economic analysis, such as capital investments, operations and maintenance costs, demand projections, and such other pertinent economic evaluation parameters.
- ii. **Department of Finance.** The agency shall appraise the risk structure and allocation of the project's fiscal requirements and government undertakings, the project's financial internal rate of return and its impact on fiscal sustainability through assessment of government's direct, contingent, and opportunity costs.
- iii. **Department of Environment and Natural Resources.** The agency shall conduct a review of the environmental impact assessment done on the project, environmental risk analysis, and the proposed mitigation measures. The review shall also cover the integration of climate change adaptation measures and disaster risk reduction, if any, as well as a review of the environmental monitoring and management plan for the project.
- iv. **PPP Center.** The agency shall be responsible for the initial review of the project, including value for money analysis, commercial viability (e.g., review validity of the financial model and underlying assumptions), bankability, and financial structuring.

## D. Project Development and Structuring

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On the other end of the project development and structuring cycle, in the case of solicited proposals, the implementing agency or LGU selects a project to propose which is in line with or identified in the priorities of medium-term development. From the point of view of contingent liability management, the key focus at this stage is the proper allocation of risks to the right parties, as discussed above. This would have parallel implications for contingent liabilities in the project which would be part of the overall approval for the project.

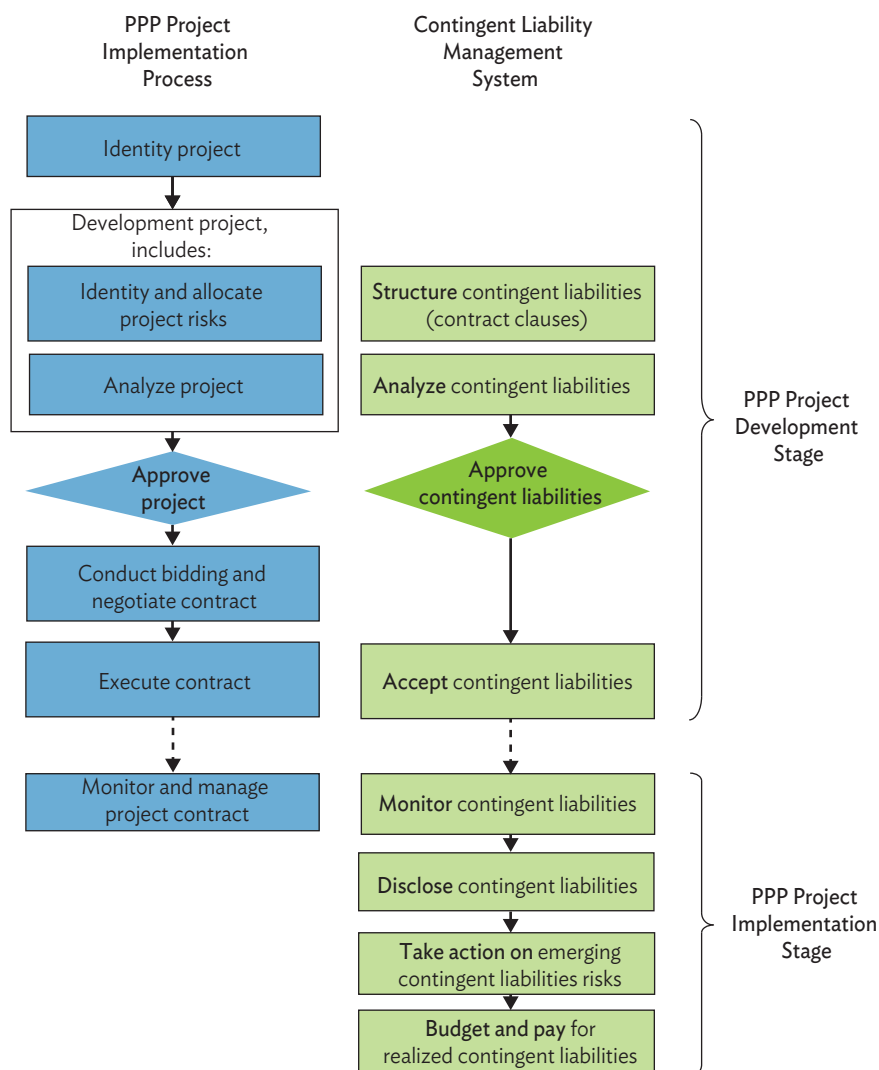
<sup>44</sup> The forms can be accessed at [http://www.neda.gov.ph/wp-content/uploads/2015/04/PIS\\_6IV15\\_Project-Evaluation-Forms-for-PPP.pdf](http://www.neda.gov.ph/wp-content/uploads/2015/04/PIS_6IV15_Project-Evaluation-Forms-for-PPP.pdf)

<sup>45</sup> Policy circulars of the Philippine PPP Governing Board can be accessed at [http://ppp.gov.ph/?page\\_id=28622](http://ppp.gov.ph/?page_id=28622)

The PPP Center will serve as the secretariat to the ICC for PPP projects and will consolidate the appraisals by the three departments for presentation to the ICC Cabinet Committee.

The fiscal appraisal will include an appraisal of the contingent liability model for the project, the valuation of contingent liabilities, and the contingent liability management plan. Unlike in some countries where the ministry

**Figure 4: Contingent Liability Management System for Public-Private Partnerships**



PPP = public-private partnership.

Note: The system described here can only work as expected if the “identify project” process works properly. A major element of this is distinguishing between good and bad PPPs via an “investment” test that should be independent of and precede the “procurement” choice.

Source: Castalia Strategic Advisors. 2010. *Pakistan: Contingent Liabilities from PPPs*. Report to the World Bank and the Ministry of Finance, Government of Pakistan.

of finance approves contingent liabilities, approval for the contingent liabilities will be part of the overall approval of the project by the whole ICC Cabinet Committee and the NEDA Board, if necessary, given the size of the project.

During the project development stage, the critical elements for proper contingent liability management process are basic project concept, initial analytics, and point agency in the government for contingent liability approval.

A basic “primordial” determination of the project concept and structure by the implementing agency, PPP Center, and the DOF can be done in the business case stage or prefeasibility stage. This prevents bad mistakes while good decisions can be made with regard to project structure. Bad mistakes carry over to the rest of the project which will be difficult to rectify later on. The implementing agency may insist on the project to be pushed as a PPP and put “pressure” that funds be allocated to project development, but if they are serious on the project concept as a PPP, this would be a waste of PPP resources. A case in point is the Quirino Highway project. Cerbotari summarized the economic rationale for government to take on contingent liabilities based on market failure, such as imperfect information, information asymmetries, or externalities.<sup>46</sup> The assessment of the prospective PPP project needs to clarify the following:

#### *Economic benefits*

- (1) What is the public good that the project is supposed to provide?
- (2) How can this be quantified (e.g., number of years in school if there are classrooms; speed in travel time; patient care benefits)?
- (3) What are the specific outcomes and affordability issues?

#### *Why PPP?*

- (1) Drivers of value for money
- (2) Components of whole-of-life cost of public sector comparator
- (3) Comparative advantages of private sector
- (4) Direct government spending and funding versus contingent liabilities

#### *Commercial proposition and/or viability*

- (1) What will attract the private sector to undertake the project?
- (2) What risks will they be willing to assume?
- (3) What risks will they not be willing to absorb?
- (4) Corollary question: Why won’t the private sector undertake the project on its own? (Market failure)

The results of this basic assessment, which will necessarily rely on basic initial data such as total project cost, initial estimates of market volumes and pricing, and weighted average cost of capital, will enlighten decisions such as whether the project would have a BOT, build–lease–transfer, build–own–operate, or other arrangement.

<sup>46</sup> Footnote 6, p. 9.

There would also be an initial assessment on the bid format (e.g., VGF, availability payment, negative bid). It would also enlighten whether the government has to retain noncore risks and contingent liabilities to make the project attract a sufficient number of investors for competitive tension. Decisions at this stage can be validated later on during market sounding with investors and lenders (for bankability issues).

The standard terms of reference for transaction advisors require the analysis of contingent liabilities.

## Risk Assessment

- Conduct project risk analysis to determine, assess, allocate, and manage risks (such as, but not limited to project construction, commercial [market risk], financial, political, economic, force majeure, and legal risks) during all project stages. The risk analysis should cover valuation, allocation, and mitigation measures.
- Based on the risk analysis, prepare a contingent liability model for the project and the DOF that quantifies the contingent liabilities, how the same shall be managed, and the funding requirements. The transaction advisor should recommend mitigation mechanisms that may be adopted by the party identified to bear each of the identified risks. In doing so, assessment and applicability of various risk mitigation mechanisms should be carried out, including review of the extent to which the risks of the project can be underwritten by commercial insurance cover and the likely cost of such cover.<sup>47</sup>

It is not clear how strictly this requirement is complied with on a consistent basis. It is also not clear at what stage the contingent liability quantification analysis is carried out. Tools for initial analytics on contingent liabilities during the project development stage would be essential to assess the contingent liabilities, particularly if certain noncore guarantees are provided. Under current practice, the DOF apparently makes an assessment of the cost of a particular guarantee. While this is not yet a formal process, and the methodology and results of the quantification may not be documented in an accessible format, there are current initiatives in the inter-agency Technical Working Group for contingent liability management to formalize and document this analysis with capacity-building support from ADB Technical Assistance.<sup>48</sup>

It is also important to have a clear process on the approval for prospective contingent liabilities in the project development stage. The current practice is for the DOF Privatization Group/CAG to be involved in vetting proposed structures and provisions in concession agreements drafted by the transaction advisor, and to perform the role as gatekeeper on contingent liability provisions such as the formula for termination payments. It is understood, however, that in the end, decisions are collegial in the sense that DOF/CAG seeks a consensus with the implementing agency, NEDA, and the PPP Center on contingent liability provisions in the concession agreements.

It would be useful to revisit the overall approach for noncore guarantees as reported in the 1995 Philippine consultative document, the possibility of unbundling them, and charging a premium for certain guarantees that

<sup>47</sup> Philippine PPP Center. Terms of reference of transaction advisors recruited through the Project Development and Monitoring Facility.

<sup>48</sup> ADB. 2014. *Technical Assistance to the Philippines on Strengthening Evaluation and Fiscal Cost Management of Public-Private Partnerships*. Manila (TA8650-PHI).

can be contributed to the contingent liability fund. However, special care needs to be given to the decision on the charge and its level; charge for a debt guarantee may be well defined and justified, but less so for minimum traffic guarantees as there is no reference for this in the market.

In summary, the issues in the current process for approval contingent liabilities are the following:

- (1) Focus in the approval criteria at the NEDA board level is not appropriate in the current macro context and for PPP projects. There can be more formal focus on managing the “scarce resource” of risk transfer and contingent liabilities. At the ICC, DBM, or DBCC level, there is no process for aggregating total contingent liabilities and monitoring this against prudential limits.
- (2) In the project evaluation forms submitted to the ICC, it is not clear whether the proposed contingent liabilities are quantified for consideration by the ICC. Therefore, ICC approvals are likely not informed by the projected contingent costs to the government.
- (3) In the project development stage, basic assessment of the project concept against the market failures that contingent liabilities are supposed to address; and the basis for value for money, and the selected PPP mode, and noncore guarantees and contingent liabilities, need to be formally defined.
- (4) It is not clear if the transaction advisors comply with the terms of reference that they prepare models for quantifying contingent liabilities, particularly for active contingent liabilities.
- (5) In the absence of such quantification, the government does not have the benefit of a “pocket calculator for contingent liabilities” in negotiations and market soundings with prospective bidders, which would be useful inputs to DOF/CAG in assessing proposed project structures, proposed termination payment formulas, risk allocation, etc.
- (6) There is also no process for the implementing agency to evaluate and commit to the quantum of contingent liabilities that the project will incur.
- (7) A central contingent liability management unit needs to be activated (e.g., Debt and Risk Management Office in the Bureau of Treasury).



# VII

## FUNDING OF CONTINGENT LIABILITIES

### A. International Experiences

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Several countries in the PPP space have created contingent liability and/or guarantee funds. Such funds serve these objectives:

- i. Provide for an orderly liquidation of any contingent liabilities that could materialize, particularly avoiding disadvantageous financing terms should the contingent liabilities crystallize during periods of financial market stress.
- ii. Assure investors and lenders regarding government's ability to discharge contingent commitments and minimize funding risk.
- iii. To the extent that the funds will have to be funded by implementing agencies according to their current outstanding of contingent liabilities, provide a mechanism for fiscal responsibility and discipline in committing to contingent liabilities (safeguard against using PPP as a form of "stealth financing").

Without the adoption of accrual accounting standards that recognize the cost of guarantees and expected contingent liabilities, the next best line of defense would be to set caps on the exposure and the value of guarantees, and to create a reserve fund for contingent liabilities. Prudential ceilings can be set on outstanding amounts, and on annual flows, in terms of the budget of the implementing agency.

Countries such as Colombia have established a Contingent Liabilities Fund to cover the funding of liabilities that materialize (Table 7). Such funds serve to assure investors and credit rating agencies that the country's

contingent liabilities are being managed against possibly threatening fiscal sustainability. In the context of making good decisions, however, the guarantee fund is also a mechanism for good governance. In the case of Colombia, implementing agencies have to contribute annually to the fund the amount of the expected value of their contingent liabilities as estimated through stochastic methods. The contribution to the fund comes from the cash budget of the implementing agency and, therefore, reveals the opportunity cost in cash in the budget of the implementing agency, highlighting the tradeoffs and enforcing discipline. It is not fiscally neutral for the implementing agency, but it should not be anyway.

**Table 7: International Experiences in Funding Contingent Liabilities**

Country	Fund	Description
Colombia	State Equities Contingency Fund	<ul style="list-style-type: none"> <li>• Created under Law 448 of 1998.</li> <li>• Funded from contributions determined by the Directorate of Public Credit, from State Entities, the National Budget, financial earnings of the funds, and recoveries of account receivables.</li> <li>• To mitigate volatility generated by contingent liabilities on the budget and debt programming process. To offer a liquid mechanism that avoid interest costs from delinquent payments.</li> <li>• Special account managed by the Fiduciaria la Previsora SA.</li> <li>• Extra-budgetary status: allows accumulation or discharge of contributions made by entities, facilitating risk management strategies.</li> </ul>
Brazil	Federal Guaranty Fund (FGP)	<ul style="list-style-type: none"> <li>• Established 2005 under law 11,079/04 regarding Federal PPP law.</li> <li>• Bank of Brazil in charge of managing FGP.</li> <li>• Aims guarantee project risk, to secure government financial obligations to private investors, avoiding government default on infrastructure contracts.</li> <li>• Mitigates risk of government insolvency, provide more liquidity.</li> <li>• Assures investors and improve credit risk.</li> <li>• Managed by Bank of Brazil.</li> <li>• Funded by capital contributions of shareholders consisting of the Federal Government, independent agencies, and public foundations, up to R\$6 billion.</li> </ul>
State of Sao Paolo, Brazil	Companhia Paulista de Parcerias (CPP)	<ul style="list-style-type: none"> <li>• To provide securities and performance guarantees to private sector using public sector assets contribute to CPP.</li> <li>• Not a fiduciary fund; not bankruptcy remote.</li> <li>• Managed by State of Sao Paolo, also the majority shareholder. Guarantees project risks (e.g., demand risk).</li> </ul>
Minhas Gerais, Brazil	Minas Gerais Guarantee Fund	<ul style="list-style-type: none"> <li>• Accounting entity without legal personality</li> <li>• Consists of budgetary allocations and initial assets of approx. R\$70 million (\$42 million).</li> <li>• Managed by State Secretary of Economic Development.</li> </ul>
Bahia, Brazil	Bahia Guarantee PPP Fund	<ul style="list-style-type: none"> <li>• Bank of Brazil responsible for transferring 12% of financial resources from State Federal District Participation Fund to the Development Agency of the State of Bahia S/A.</li> <li>• Maintained in a separate bank account with a specific aim of guaranteeing PPP contracts where State of Bahia is the public partner.</li> </ul>
Mexico	Fondo Nacional de Infraestructura (FONADIN)	<ul style="list-style-type: none"> <li>• Mexican National Development Bank (Banobras) as the trustee of FONADIN.</li> <li>• Provides financial guarantees as the development bank.</li> <li>• FONADIN offers equity support and subordinated debt to PPP projects which do not have sufficient financial strength.</li> <li>• Also offers credit enhancements to increase access to banks or capital markets:</li> <li>• First loss guarantee: FONADIN assumes first loss and pays prior to disbursement of other guarantees.</li> <li>• Pari passu: disburse portion of funding gap.</li> </ul>

*continued next page*

Table 7 *continued*

Country	Fund	Description
		<ul style="list-style-type: none"> <li>• Last payment: disburse shortfall after guarantees have been paid.</li> <li>• Mixed guarantees: combination of first loss and pari passu guarantees.</li> <li>• Performance guarantees on 15% of investment budget on construction risks.</li> <li>• Also during initial stages of operation.</li> </ul>
Indonesia	Indonesia Infrastructure Guarantee Fund (IIGF)	<ul style="list-style-type: none"> <li>• Established in 2009.</li> <li>• To encourage participation of the private sector in infrastructure development.</li> <li>• Improve credit worthiness of infrastructure projects.</li> <li>• Minimize exposure from contingent liabilities and sudden shocks to state budgets.</li> <li>• Initially subscribed by Government of Indonesia IDR1 billion.</li> <li>• Capital has since been increased to IDR3.5 billion.</li> <li>• Guarantee can be provided by jointly by MOF and IIGR, or solely by IIGF.</li> <li>• Will enter into guarantee agreement on risks allocated to the government contracting agency.</li> <li>• Guarantees typically exclude termination payments, which are funded directly from the budget by the Ministry of Finance.</li> <li>• IIGF will pay investor in case contracting agency fails to perform.</li> <li>• Recourse agreement with contracting agency to reimburse IIGF for any payments made by IIGF to private investors.</li> </ul>

IDR = Indonesian rupiah, PPP = public-private partnership, R\$ = Brazilian real.

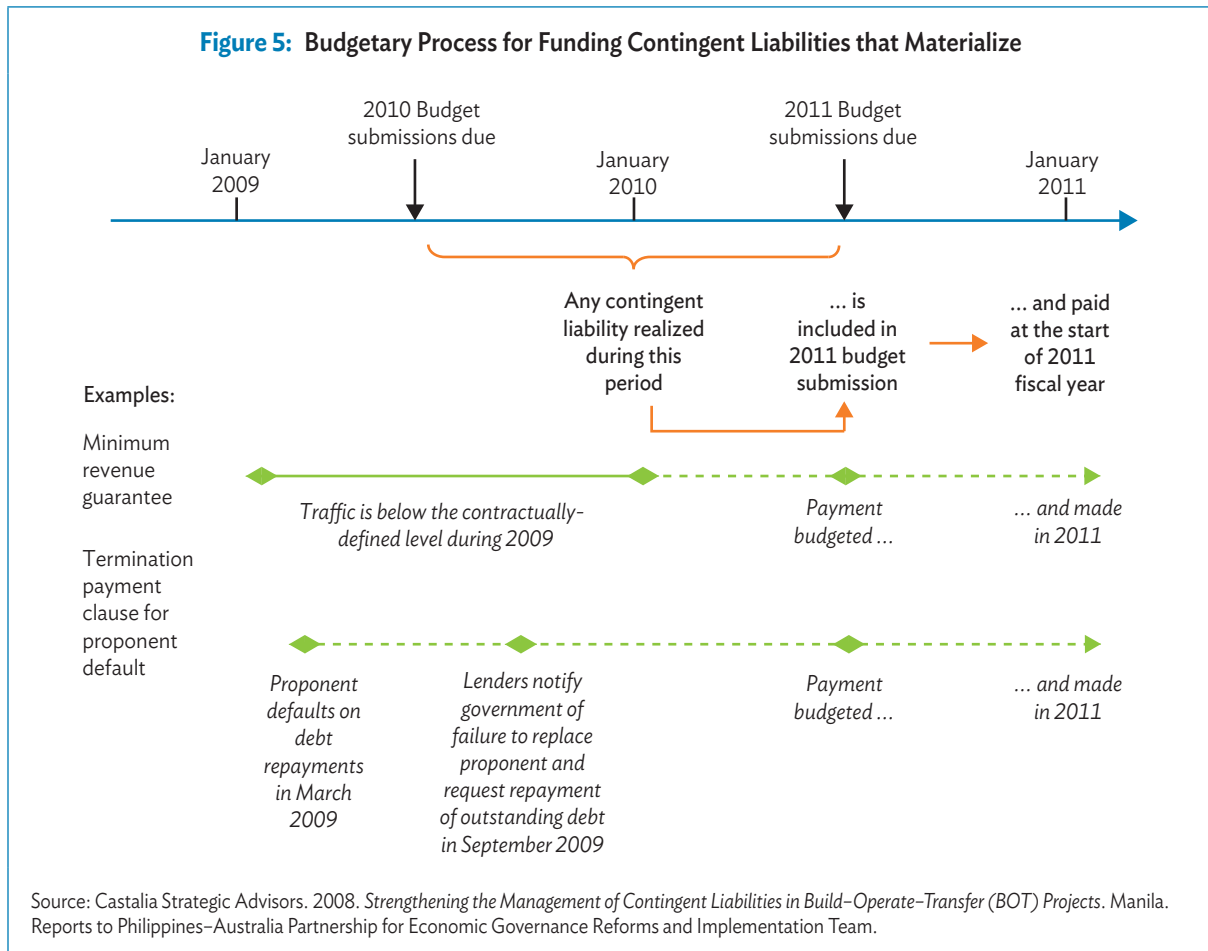
Source: Various sources.

## B. Philippine Situation

Under the law, national government agencies can only source funds from budget appropriations. If there is no budget appropriation for a contingent liability that materializes in the middle of the year, the implementing agency will have to include that in its proposed budget for the following year. If Congress approves the proposed appropriation, the implementing agency can make the payment 1 to 2 years after the liability materialized (Figure 5). If Congress disapproves the proposed appropriation, the implementing agency will have to try again the following year. Investors and lenders are therefore subject to appropriation risk and are likely to price this into their bid and lending rates.

One way the government has sought to address the appropriation risk and to assure investors and lenders is the inclusion of the Risk Management Program in the Unprogrammed Fund of the 2014 and 2015 General Appropriations Acts. In 2014, the amount authorized was P20 billion. In 2015, the amount was increased to P30 billion. The Unprogrammed Fund approach is fiscally neutral because the amounts cannot be availed of unless there are new or additional sources of funds or, to be more specific, only when there are (i) excess collections from previously identified nontax revenue sources, (ii) collections from new tax laws or new nontax revenue sources, or (iii) newly approved loans for foreign-assisted projects. Apart from the Risk Management Program, the Unprogrammed Fund also covers other items (e.g., budgetary support for GOCCs, support for infrastructure projects and social programs, general fund adjustments for use of excess income by agencies).

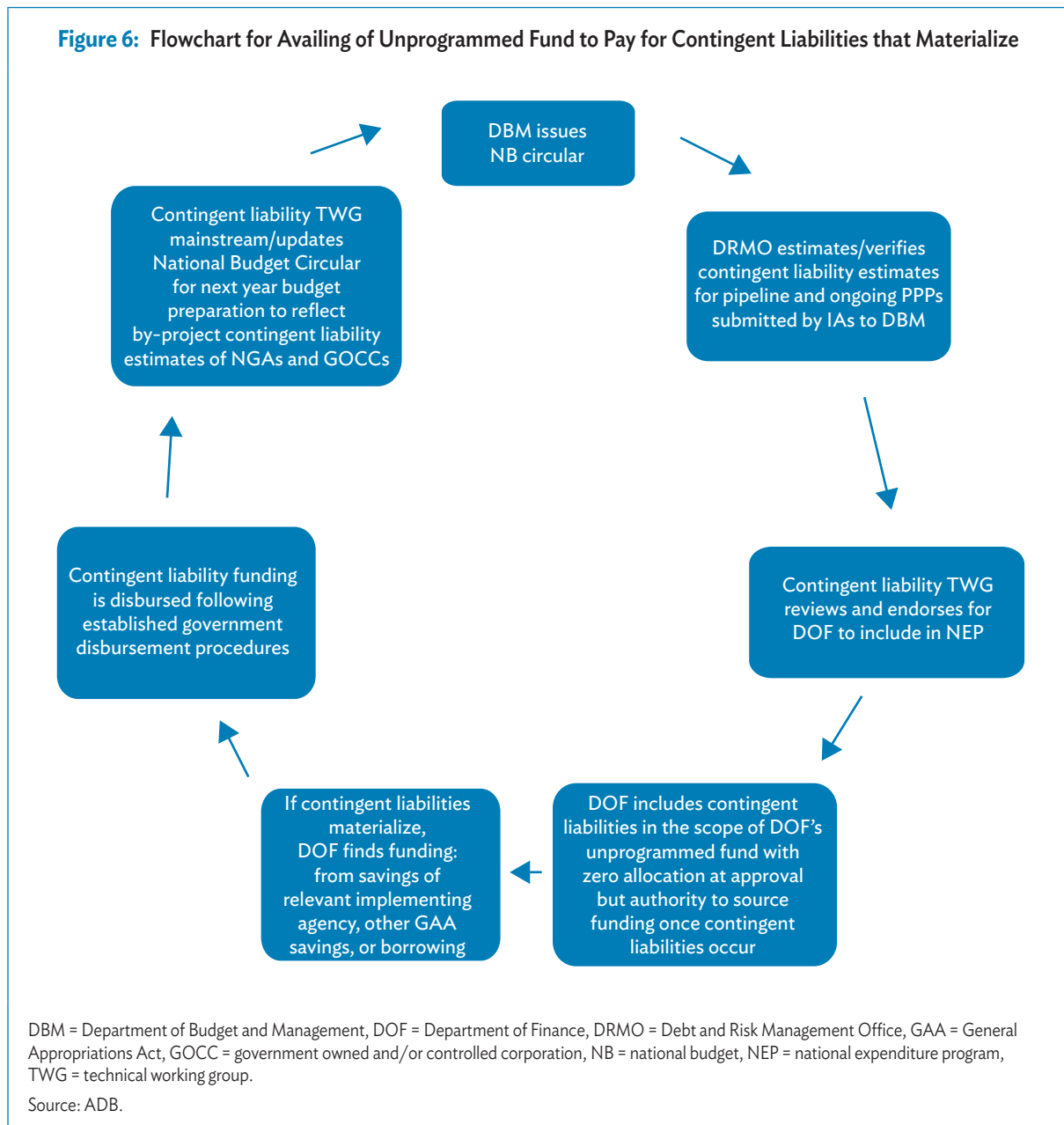




The Unprogrammed Fund approach could lead to faster payment for contingent liabilities that materialize than budgeting for contingent liabilities after they materialize. However, availability of funds for actual payment for materialized contingent liabilities would still depend on the availability of new or additional funds mentioned above and—even if such funds are available—prioritization of contingent liability payments against spending on other items covered under the Unprogrammed Fund (Figure 6).<sup>49</sup> It could also lead to irresponsible or moral hazard behavior by implementing agencies since their budget may not be affected by the contingent liability that materialized, possibly because of actions that they took or did not take.

An alternative would be to establish a line of credit from a multilateral agency. The line will be drawn upon if a contingent liability materializes. The proceeds of the loan will be paid directly to the proponent or beneficiary of the contingent liability. If the implementing agency is a national government agency, repayment of the loan from the multilateral agency will be included in its future budget. If it is a GOCC, the loan proceeds (drawn by the national government) will be booked as Net Lending of the national government to the GOCC which the GOCC should then pay for.

<sup>49</sup> Currently there is no mechanism to prioritize a specific item or program in the Unprogrammed Fund.

**Figure 6: Flowchart for Availing of Unprogrammed Fund to Pay for Contingent Liabilities that Materialize**

GOCCs have their own charters, balance sheets, and revenue streams. They, therefore, have more flexibility to pay for contingent liabilities immediately. However, if they do not have enough funds and require Net Lending from the national government, this would have to be in the annual budget or Net Lending Program, or included in the General Appropriations Act in the next fiscal year. To ensure that GOCCs have enough funds to pay for the contingent liability immediately or at least repay the national government for any advances that they make, GOCCs may be required to create and fund Special Reserve Funds. This was done by the MWSS in 1997 when it entered into concession agreements with Manila Water and Maynilad.

An integral part of the concession agreements was that the concessionaires would receive Letters of Undertaking from the Republic of the Philippines signed by the secretary of finance. The secretary of finance consented to issue the letters on the basis of certain commitments made by the MWSS, foremost of which was the creation of a Special Reserve Fund with the Bureau of Treasury (BTR) to answer for and satisfy any financial obligations that MWSS may incur in respect of the concessionaires under the terms of the concession agreements. The objective of the arrangement was for MWSS to have sufficient reserves, funds, and assets so that, to the extent possible, it would be unnecessary for the concessionaires to call upon the Letter of Undertaking or, if that could not be avoided, for MWSS to compensate the Republic of the Philippines for any payments it may need to make under the Letter of Undertaking.

To start the fund, P100 million out of the total commencement fees payable by the concessionaires was deposited with the BTR within 30 days from the issuance of the Letter of Undertaking. Additional funds come from liquidation into cash of other current assets. The funds deposited in the fund are invested in a special series of government securities issued by the BTR, with maturity dates properly spaced so that a portion, if not the total amount, can be made available immediately in the event of a call on the Letter of Undertaking. If the fund is not enough to meet the obligations of MWSS, MWSS can request the necessary appropriations from Congress following the regular budgetary cycle or avail of the amount authorized for the Risk Management Program under the Unprogrammed Fund if there are new or additional sources of funds.

### **C. Creation of a Contingent Liability Fund**

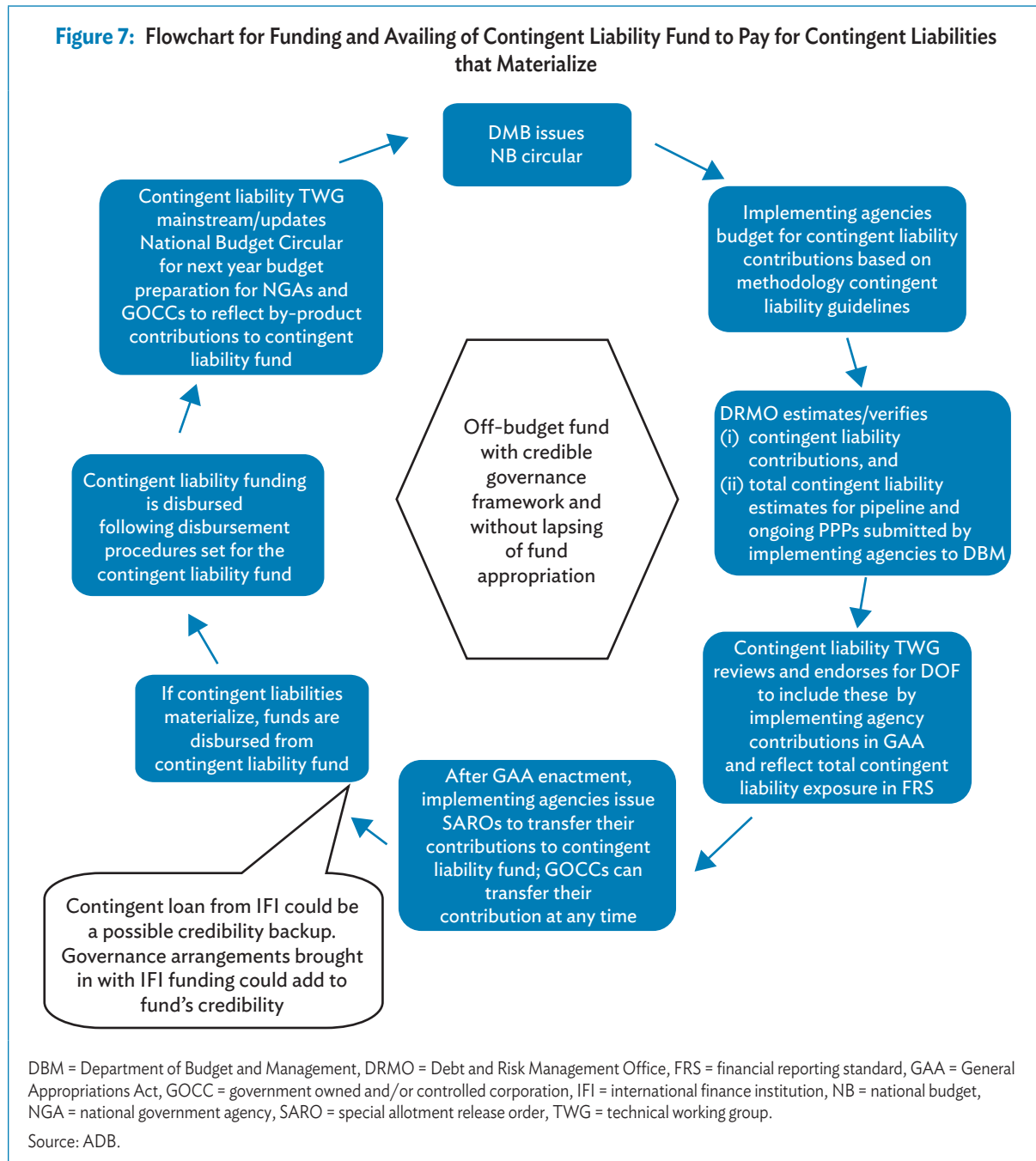
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Another alternative is the creation of a Contingent Liability Fund through legislation as described (see preceding paragraph). Once the Contingent Liabilities Fund is created by law, annual budgetary appropriations can be included in forthcoming General Appropriations Act. The budgetary appropriations for the Contingent Liability Fund will form part of the budgets of the implementing agencies (Figure 7). The contributions of agencies to the fund will be based on the expected value of their contingent liabilities using stochastic methods. If the expected value of their contingent liabilities is higher than their previous contributions to the fund, the agencies will have to increase their contributions. The fund is, therefore, not fiscally neutral because appropriations and the corresponding disbursements will be made. These will add to the budget deficit or reduce any surplus. Making the agencies contribute to the fund under their budget ceilings will promote fiscal responsibility and compliance with the commitments they made in their PPP contracts. As proposed above, the appropriations will be dedicated and permanent and will not revert to the General Fund if not disbursed during the life of the project. Some mechanism can be introduced to give agencies some incentive to make sure that the contingent liabilities in their projects do not materialize.

The contributions to the Contingent Liability Fund can be considered as “advanced savings” for specific contingencies for which the government is committed to make disbursements under PPP contracts. The Contingent Liability Fund will operate on pooling of the costs of risks allocated to the government such that the contributions of agencies will be lower than the nominal amount of their contingent liabilities. It will not be a guarantee facility which may require a one-to-one matching of the amount guaranteed. It will be calculated on a portfolio basis and projects will be able to draw on the fund without a ceiling, even if it goes beyond the contributions of the agencies or their private sector partners. This reinforces the need for capacity building in the quantification of contingent liabilities on a probability-adjusted expected value basis.

Other sources of funding for the contingent liability fund could include the following:

- i. proceeds from negative bids in PPP projects
- ii. premiums on specific noncore guarantees paid by private sector proponents, and
- iii. support from international finance institutions (IFIs) which can be on a revolving basis similar to Project Development and Monitoring Fund.



There will be a contingent liability resolution or clearing mechanism to facilitate within-government processing of claims. Standardized procedures for disbursements from the contingent liability fund could be made part of PPP contracts. With the ready pool of funds and clear and transparent disbursement procedures, investors and their lenders can be confident of full and timely payments of contingent liabilities that materialize.

The Contingent Liability Fund will have to be established either as a separate GOCC, as a subsidiary of a GFI, or as an asset in the balance sheet of a GFI. As in other countries, the management of the fund could be mandated to an independent professional fund manager. The DOF-CAG as well as the PPP Center can act as advisors to the fund manager given their familiarity with the terms of the PPP contracts.

A distinction may also need to be made in the use of the Contingent Liability Fund. If a contingent liability materializes because of core risks which the government has assumed, government funds in the Contingent Liability Fund should be used. If a contingent liability materializes because of noncore risks which the private sector made government assume or paid guarantees for through contributions to the Contingent Liability Fund, the contributions from private sector proponents should be used.



# VIII

## CONTINGENT LIABILITIES DISCLOSURE AND ACCOUNTING ISSUES

In the private sector, modern accrual accounting standards are a main line of defense against unsound business decisions. Episodes of major corporate and financial sector crises in the last 10 to 20 years have resulted in the strengthening of financial accounting standards. However, government accounting practices are typically on a cash basis and expose the government to inadequate valuation and recognition of its risk exposures. As pointed out by Irwin, governments are routinely under pressure to reduce their reported debt and deficits. The cost of granting a guarantee does not usually affect the reported deficit or the quantum of guarantees as they are issued. Guarantees are only recognized when they are called (or if the budget department anticipating the high likelihood for a contingent liability to materialize puts a notation in the budget disclosure).

GOCCs tend to follow reporting standards of commercial firms and, in this sense, are more advanced than central governments. In the case of the National Power Corporation, its obligations in Power Purchase Agreements had been reported as liabilities while claims under the BOT contract were booked as leased assets.

The Philippine government is following the trend in other countries to adopt modern accounting standards so that cash flows are reported in the traditional government accounting, while noncash costs and revenues are reported in an income statement. The trend toward international accounting standards such as the International Financial Reporting Standards (IFRS) superseding local standards is also a positive development. The International Public Sector Accounting Standards, adapted from the IFRS for government features, has been developed by the International Public Sector Accounting Standards Board. The International Monetary Fund (IMF) has also created an accrual accounting standard for government financial statistics.

As pointed out by Hemming et al., there is a hierarchy of standards for the treatment of guarantees and other contingent liabilities for government entities on an accrual basis (footnote 3). If the International Public Sector Accounting Standards is not the norm followed, the entities should comply with IFRS, incorporating International Accounting Standards and interpretations. Judgment needs to be exercised on whether a guarantee is a liability or a contingent liability. A contingency would be recognized as a liability if it is deemed probable (more likely than not) that “an expense will occur and when a reasonably reliable estimate can be made of the amount of the expense.”

Issues remain, however, when it comes to reporting contingent liabilities in a consistent manner. As pointed out by Irwin:<sup>50</sup>

International Accounting Standard 37 treats “Provisions, Contingent Liabilities, and Contingent Assets.” Some guarantees may be considered contingent liabilities for the purposes of this standard. The standard’s complex definition of a contingent liability is as follows (International Accounting Standards Board 2004, 1531–32):

- (a) A possible obligation that arises from past events and whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the entity.
- (b) A present obligation that arises from past events but is not recognized because: (i) it is not probable that an outflow of resources embodying economic benefits will be required to settle the obligation or (ii) the amount of the obligation cannot be measured with sufficient reliability.

Contingent liabilities, as defined, are not recognized. That is, incurring a contingent liability doesn’t increase the government’s liabilities or its accrual deficit. A guarantee might create a contingent liability. If so, it would not be recognized. Although a government’s exposure to risk from guarantees is often referred to under the rubric of contingent liabilities, guarantees need not create contingent liabilities as defined by IFRS, for there are two other categories into which guarantees might fall: derivatives and insurance contracts. (Indeed, the International Accounting Standards Board has proposed doing away with the term *contingent liability*.)

At the micro level of the individual implementing agency or GOCC, the disclosure of contingent liabilities is prescribed by the Philippine Government Accounting Standards in the following manner:

Contingent liabilities, such as those arising from guarantees against debt default, shall be presented and explained in the notes to the financial statements, indicating, among other things, the name of the debtor, the creditor, the amount of debt guaranteed, the maturity date of the debt and other relevant information.<sup>51</sup>

<sup>50</sup> Footnote 1, pp. 116–117.

<sup>51</sup> Philippine Government Accounting Standards. Accessible at the website of the Philippines Commission on Audit at [www.coa.gov.ph](http://www.coa.gov.ph)

At the macro level, the appropriate venue for disclosing contingent liabilities would seem to be in the annual General Appropriations Act and in the Fiscal Risks Statement which the Philippine government has started to issue since 2012. As pointed out by the IMF:

Empirical evidence...highlights the macroeconomic significance of fiscal risks from various sources. Unexpected changes in macroeconomic variables, most notably in the case of exchange rate depreciations, often have major consequences for fiscal sustainability. A key role is also played by calls on contingent liabilities in the banking system, other parts of the public sector (state-owned enterprises and sub-national levels of government), or the government's interactions with private sector agents (e.g., PPPs).

A number of broad messages emerge from the review of country experiences:

- i. Effective identification of fiscal risks requires a clear allocation of responsibilities for the various parts of the public sector in assessing and reporting fiscal risks and that procedures be in place to ensure that the entity that plays the main role in determining fiscal policy (typically, the Ministry of Finance) has access to relevant data.
- ii. Comprehensive disclosure of fiscal risks is desirable to facilitate identification and management of risks. However, disclosure modalities in some areas should avoid engendering moral hazard from a perception of an implicit blanket guarantee (e.g., in the banking system) and ensure that the state's economic interests are not prejudiced.
- iii. Cost-effective risk mitigation begins with sound macroeconomic policies and public financial management practices. It also consists of practices that require justification for taking on fiscal risks, and that make it necessary for private sector agents to pay guarantee fees or to share in the risk. It may also involve using insurance instruments, though this remains an exception in light of limited market development to date.<sup>52</sup>

The Philippines is currently in line as the first country in Asia to participate in the IMF's Fiscal Transparency Assessment exercise, a voluntary surveillance tool which elaborates on a country's fiscal position based on three pillars: fiscal reporting, forecasting, and risk analysis. Based on the IMF's updated Transparency Code, the Fiscal Transparency Assessment replaces the Fiscal Report on the Observance of Standards and Codes initiative of the IMF and World Bank and responds to key weaknesses in surveillance which were brought to the fore in recent episodes of crisis. The Fiscal Transparency Assessment has been piloted in Ireland, Costa Rica, and Bolivia.

At present, the main venue for the disclosure of contingent liabilities is the reference to the government's exposure to contingent liabilities included in the Fiscal Risk Statement. Until the government makes specific progress in shifting to accrual accounting and resolving the issues raised by Irwin, the standard of reporting contingent liabilities will not likely be at par with the accrual-based accounting practice in the private sector.

<sup>52</sup> IMF. 2008. *Fiscal Risks—Sources, Disclosure, and Management*. Prepared by the Fiscal Affairs Department.





## RECOMMENDATIONS TO IMPROVE CONTINGENT LIABILITY MANAGEMENT IN THE PHILIPPINES

IX

The past Philippine experience with the public-private partnership (PPP) approach has been somewhat problematic and in some instances resulted in significant fiscal costs given the poor structuring of projects and deferral rather than true transfer of risks. In the initial phase, failure to use the PPP option before the onset of a crippling power crisis left the government with no choice but to assume noncore risks that rendered the country vulnerable to foreign exchange depreciation and economic recession. Failure to allow automatic recovery of big foreign exchange losses and inability to manage sponsor risk in the Metropolitan Waterworks and Sewerage System (MWSS) concessions resulted in a bankruptcy and protracted restructuring process. Lack of transparency and failure to follow the regulatory framework for unsolicited proposals resulted in an onerous PPP contract in the Metro Rail Transit-3 (MRT-3) project which the government is still trying to resolve. The similar lack of transparency and adherence to regulatory norms also resulted in a costly and litigious process in the case of Ninoy Aquino International Airport (NAIA) Terminal 3.

The government has relaunched the PPP approach in increasing the project pipeline and the range of sectors. Learning from the past, the government is trying to avoid assuming noncore risks in the new pipeline projects which, however, is limiting the number of bidders, and exposes the government to sponsor risk. Its institutional framework for managing contingent liabilities is still limited. There is no formal process for approving contingent liabilities. The approval criteria in the National Economic Development Authority (NEDA) Board is oriented toward managing scarce foreign exchange resources and fiscal expenditures and does not seem to have a formal focus on managing retained risks and contingent liabilities. There is also no formal process for managing aggregate contingent liabilities and setting prudential limits. Investors are exposed to appropriation risk and liquidity risk on contingent liabilities that may materialize.

On December 2013, the Investment Coordination Committee (ICC) approved changes in the process of appraising PPP projects. The PPP Center would act as secretariat to coordinate appraisal of PPP projects presented for approval to the ICC. It would also carry out the review of the value for money, commercial viability, bankability, and financial structuring. The NEDA would continue the appraisal of the socioeconomic aspects of the project including the prerequisite analysis of the technical, institutional, environmental, and financial aspects. The Department of Finance (DOF) would be responsible for appraisal of the project's risk allocation, financial viability, and fiscal sustainability. Final guidelines on the new institutional arrangement for appraisal of PPP projects is being finalized by the PPP Center.

The rationalization plan approved for NEDA in June 2013 includes the creation of a Value, Risk Analysis, and Infrastructure Regulation Division in the Infrastructure Staff. The division will conduct value, risk, and price escalation analyses, and review draft contracts of PPP projects. The Program Formulation Division of the Public Investment Staff would be restructured into an Investment Programming Division to serve as focal point for processing of PPP projects for ICC and NEDA Board review.

For its part, the DOF has set up an inter-agency Contingent Liability Monitoring Group headed by the National Treasurer. The group leads the preparation of the contingent liability analysis for the government's annual Fiscal Risks Statements including PPP-related contingent liabilities.

The rationalization plan submitted by the Bureau of Treasury (BTR) to the Department of Budget and Management (DBM) includes the establishment of a Debt and Risk Management Office (DRMO) and a Contingent Liability Division within the DRMO. The division would have six permanent staff. It would be responsible for managing and funding contingent liabilities at the aggregate level. The DRMO would take over the functions of the Debt and Risk Management Division set up in May 2009 in the International Finance Group of the DOF. The DOF staff assigned to the Debt and Risk Management Division were transferred to the BTR for absorption into the DRMO upon its formal creation.

Both the Contingent Liability Monitoring Group and the DOF need technical support to carry out their responsibilities to control and manage contingent liabilities arising from PPP contracts. The rising number and, in some cases, complexity of PPP projects in preparation and implementation stages poses an additional challenge to the DOF's ability to properly identify and value contingent liabilities during project appraisal, to closely monitor ongoing PPP contracts and promptly identify contingent liabilities that may materialize, and to properly and promptly address claims for payment of contingent liabilities that actually materialize.

In addition to the BTR, several operating groups in the DOF are involved in the various stages of processing PPP projects and payment claims of materialized contingent liabilities. The Corporate Affairs Group (CAG) represents the DOF in the Governing Board of the PPP Center and reviews draft PPP contracts. The CAG and International Finance Group have representatives in the Technical Board of the ICC which approves PPP projects prior to bidding. The International Finance Group is responsible for negotiating loans from international financial institutions (IFIs) some of whom may be tapped to provide contingent loans to a Contingent Liability Fund. IFIs also provide technical assistance to oversight and implementing agencies to build up their capacity to undertake or oversee PPP projects or programs. The Domestic Finance Group normally represents the DOF

in the Technical Board of the Development Budget Coordination Committee (DBCC) of the NEDA Board.<sup>53</sup> Proposals to create and fund a Contingent Liability Fund would need to be supported by the DBCC. The MOF's Municipal Development Fund Office has established a P1 billion PPP Fund that local government units (LGUs) can access to finance their share in PPP projects.<sup>54</sup> The Municipal Development Fund Office also has the Project Technical Assistance and Contingency Fund which LGUs can access to finance the cost of advisors that would help LGUs develop feasibility studies for PPP projects.

Among other things, capacity-building efforts for the DOF and Contingent Liability Monitoring Group should include the following:

- i. optimal risk allocation between public and private sector partners;
- ii. pricing of guarantees for noncore risks assumed by the public sector partner;
- iii. standard criteria and wording for acceptable guarantees and contingent liabilities;
- iv. consistent methodology for identification and quantification of contingent liabilities, including their costs and benefits;
- v. formal consideration of quantified contingent liabilities in the PPP approval process;
- vi. policy and methodology for setting prudential limits on aggregate contingent liabilities;
- vii. process for provisioning and funding payments for contingent liabilities including creation of a Contingent Liability Fund;
- viii. clarification of public sector accounting for PPPs and their direct and contingent liabilities;
- ix. disclosure standards and procedures for contingent liabilities;
- x. functional systems, processes, and procedures for the Contingent Liability Monitoring Group, including getting the necessary information from implementing agencies in a timely manner;
- xi. fiscal rules to manage direct and contingent costs of PPP projects; and
- xii. processes and procedures for claiming and processing claims for contingent liabilities that materialize.

<sup>53</sup> Depending on the topic, other groups of MOF may be coopted to attend the meeting of the Development Budget Coordinating Committee.

<sup>54</sup> Loan terms and conditions depend on the income class of the LGU and the type of project. Interest rates range from 5.00% to 5.75%. The repayment period is generally 15 years, inclusive of a 3-year grace period.

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## **Philippines: Management of Contingent Liabilities Arising from Public–Private Partnership Projects**

Given the rapid growth of the public–private partnership program (PPP), the Philippine government has initiated reforms to strengthen the framework for managing contingent liabilities arising from PPP projects. This study shows that major directions requiring further effort include (i) better pricing of government guarantees, (ii) adoption of methodology for quantification of contingent liabilities, (iii) setting prudential limits on PPP contingent liabilities, (iv) development of procedures for payment of materialized contingent liabilities from the national budget’s unprogrammed fund, and (v) in the medium term, setting up a contingent liabilities fund financed through budget appropriations and contributions of project sponsors.

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