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Public Private Partnerships: Management of Fiscal Liabilities

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Public Private Partnerships:

Management of Fiscal Liabilities

Report to the Chongqing Municipal Government

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Acronyms and Abbreviations

CLF	Contingent Liability Fund
CL	Contingent Liability
IAS	International Accounting Standard
IA	Implementing Agency
PPP	Public Private Partnership

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1 Introduction

This report aims to help the Chongqing Municipal Government establish processes, frameworks and institutional structures for the management of the fiscal liabilities under Public Private Partnership (PPP) arrangements.

Procuring projects through PPP structures has the potential to reduce life cycle costs and risk to the government and to provide services efficiently provided the risk allocation between the government and the private section is appropriate.

But, even with appropriate risk allocation, PPPs inevitably give rise to liabilities for the government through either risks that the social capital sector cannot manage and will not accept or obligations and commitments that the government agrees to accept and undertake for the PPP project.

These liabilities need to be managed through all stages of a PPP from project inception to the operations phase. This is because they are “sovereign” obligations that have fiscal implications for the government and to ensure that PPPs are value for money.

This document is set out as follows:

- It first looks at how PPPs give rise to fiscal commitments—both direct liabilities and contingent liabilities and defines both—Section 2
- Explains why liabilities need to be managed and the fiscal risk of liabilities—Section 3
- How to disclose, budget, pay for, and account for government liabilities to PPPs—Section 4
- Disclosing contingent liabilities—Section 5; and
- Accounting for contingent liabilities—Section 0.

A separate report discusses the valuation of contingent liabilities.

2 Fiscal Commitments from PPPs

While PPPs can result in more efficient delivery of services, they do give rise to fiscal commitments. In this section we outline the benefits and limitations of PPPs and go on to set out the two types of liabilities that can arise from PPPs—direct liabilities and contingent liabilities.

2.1 The fiscal benefits

Delivering projects as PPPs has the potential to reduce life cycle costs and risks to the government and to provide services more efficiently.

The key to achieving successful implementation of PPPs is an appropriate risk allocation between the government and the social capital sector. Appropriate in this context means that risks are allocated to the party that is best able to manage, mitigate and ultimately bear the risk—that is risks are allocated efficiently.

If the risk allocation between the public and social capital sector is efficient, then the resulting transfer of risk to the social capital sector can remove direct commitments such as borrowing for infrastructure from the government balance sheet. This generates fiscal savings.

If the incentives are appropriately aligned, the long term costs of providing a service are likely to be lower for a PPP than direct government provision. This is mainly because: of the adoption of a life cycle approach to asset management including full funding of maintenance, and because the social capital partner to a PPP is likely to be a more efficient operator than the public entity that would have otherwise deliver the services. Sources of greater efficiency include the incentives provide by competition and the operational autonomy a PPP provides to the service provider.

PPPs may also provide fiscal savings if they spur reforms in user charges so they better match costs—or at least a more transparent subsidy mechanism where services are currently provided below cost.

The fiscal savings from PPPs give headroom for other expenditure while promoting investment.

In this section, we:

- Show how efficient risk allocation inevitably leads to the government accepting a level of contingent liabilities as well as direct fiscal commitments—Section **Error! Reference source not found.**
- Define contingent liabilities and contrast them with direct fiscal commitments—Section **Error! Reference source not found.**

2.2 Financing not funding

While PPPs offer benefits to a budget, they have fiscal implications. PPPs are not "cost free" to a government. The effect of procuring a toll road through a PPP with an availability payment rather than a conventional payment is to substitute a series of period payments (the availability payments) for the upfront payment to construct the toll road. In broad terms, the net present value of the future stream of availability payments that the government has committed to is equal to the upfront capital cost plus future operations and maintenance costs. PPPs change the time profile of payments from government rather than the total cost to government.

Thus while PPPs **provide a source of finance**, **they do little if anything to create additional sources of funding**—the government commitment is the same, only the timing is different. The government needs a funding source (taxation revenue or tolls) in order to either make the PPP availability payments or amortise the financing of the capital cost if a project is delivered in a conventional manner.

2.3 Types of fiscal commitments

Under a PPP, the government almost always bears some risk or provides some support that gives rise to an on-going fiscal commitment—either a contingent liability or an actual direct liability.

This is because the government makes commitments to contribute to the project. This might be in the form of supplying the land needed for the project, providing various approvals, permits and licenses, or providing funding where users charges aren't sufficient.

The government also typically accepts some risks that either the social capital sector cannot manage or the government is best placed to manage—for example force majeure, exchange rate risk, or a change of law event. The social capital sector cannot manage or mitigate these risks and if asked to do so the project would be commercially unviable. While the government is not necessarily best placed to manage these risks (and may not be better placed than the social capital sector) it needs to accept these risks to make the project bankable. Some of these risks, for example, currency incontrovertibility, may be at least partially under its control.

The fiscal commitments that the government accepts under a PPP in order to subsidize or accept risk can be of two types:

- **direct**—where the occurrence of the payment obligation is known, although uncertainty may remain as to the size; or
- **contingent**, where the occurrence, value and timing of the payment depend on some uncertain future event.

2.4 Contingent liabilities

But, even with appropriate risk allocation, PPPs inevitably give rise to contingent liabilities for the government through either:

- **Risks that the social capital sector cannot manage and will not accept** such as currency incontrovertibility or force majeure. The government is not necessarily best placed to manage these risks (and no better placed than the social capital sector) but needs to accept these risks to make the project bankable for the social capital sector.

  These clearly are contingent liabilities in that they are specified risks or events in the PPP agreement where the government will make the termination payments specified if the event occurs; or

- **Obligations and commitments that the government agrees to accept and undertake** for the PPP project. These can be physical obligations such as the provision of land or rights of way or interfaces to other infrastructure, or financial support through making viability gap payments, availability payments, or other forms of project revenue.

> These obligations and commitments aren't contingent liabilities in themselves but failure of the government to meet them could give rise to a contingent liability.
>
> Securing of the right of way for a toll road, for example, is not a contingent liability: the contingent liability is one that arises if the right of way is not secured and the contract specifies an obligation that arises out of that event. The ultimate obligation could be the trigger for termination payments for government default as specified in the PPP agreement.

In this context, it is immaterial if the obligation has been directly entered into by the government, or entered into by a government, department, agency or state-owned enterprise—the implementing agency (IA). The contingent liabilities from a PPP project are "sovereign" obligations that the government has committed to discharge through execution of the PPP agreement.

In most countries, contingent liabilities also include guarantees provided explicitly by the government. In the PRC, the Law on Guarantees prevents a government from issuing such guarantees so such contingent liabilities should not arise. But if any guarantees issued by a government's financing vehicle (e.g., a PPP fund) or SOE, then they would be a contingent liability for that entity.

The contingent liabilities need to be recognised and managed through all stages of a PPP from project inception to the operations phase:

- To ensure that **appropriate comparisons between public financing and PPPs** are made. It needs to be clarified if PPPs really do provide value for money when contingent liabilities are taken into account; and
- To understand and quantify the long-term and cumulative fiscal effect of PPPs to ensure **fiscal sustainability.**

2.5 Liabilities but not debt

Government commitments to PPPs are materially different to government debt and require a different management approach. When a government borrows, it uses the borrowed funds and the government is obliged to repay the debt regardless of how well the borrowed funds are used. Government liabilities to PPPs are in the nature of payments for services delivered. These liabilities are linked to the performance of the service provider, i.e., the social capital partner to a PPP.

A PPP is different to a build-transfer project, which is a conventionally delivered project but with a deferral of government payments to the contractor. The government commitments to a build-transfer project are a debt. A build-transfer project is not a PPP.

3 Managing Liabilities to PPPs

The government's direct and contingent liabilities to PPPs are long term. They extend over the lifetime of the contract and thus require management across the lifecycle.

In this section we look at the need to manage liabilities, the challenges that they pose to the annual budget process, and outline a suggested approach to their management across the project lifecycle.

3.1 The need to manage liabilities

Liabilities arising from the PPP program need to be managed to:

- **Improve incentives to make good decisions**, to help ensure:
  - The government accepts risks and approves liabilities that provide value for money
  - Decision makers manage existing risks well.
- **Improve credibility** by:
  - Making the government's exposure transparent and signal a commitment to managing risk, thereby decreasing the likelihood that banks, other sources of finance, and credit rating agencies and others assessing sovereign risk will overestimate the risk exposure
  - Implementing a systematic process that defines how payments of liabilities will be made reduces uncertainty, thereby increasing investors' confidence, attracting greater investment, and lowering the cost of borrowing; and
- **Reducing adverse fiscal impact** by implementing a systematic process that reduces the uncertainty of payment obligations, minimizes the cost of realized liabilities, and limits the impact of payments on the fiscal deficit, debt levels, and budget priorities.

In the absences of a formal and rigorous monitoring and management process it is likely that these liabilities:

- May not be centrally reported, managed and monitored as a result of their non-cash and long term nature and the difficulty in quantifying them. Contingent liabilities may not even be recognised;
- May create possible biases in decision making and investment in favour of PPPs which may crowd-out other expenditures, and make the government bear additional and unnecessary risks;
- May decrease the credibility and predictability of fiscal policy; and
- May decrease the propensity of the social capital sector to participate in further PPP programs—or raise the cost of their investment as they perceive higher risks.

As a result, liabilities may become significant enough to challenge the country's fiscal position and may blind governments to future fiscal costs and risks.

Banks, other sources of finance, and rating agencies have concerns about liabilities and need assurance that commitments from government through implementing agencies and other entities under PPP arrangements are properly monitored and managed.

In the absence of good information about liabilities and a high degree of transparency, banks, other sources of finance, and rating agencies are likely to make arbitrary adjustments that are likely conservative and overstate the "true" position.

3.2 The challenges of managing liabilities

PPP liabilities are long term, extending over the lifetime of the contract. Payments for contingent liabilities are by definition uncertain, and in most cases can arise suddenly and unexpectedly.

Most governments, plan, budget, and report on a short timescale, and through a process that is designed to be relatively inflexible to "in-year" changes. This means managing liabilities to PPPs poses four key challenges:

- Long term commitments are often not subject to the usual affordability checks on government expenditures provided by the annual budget and medium-term planning processes, since payments occur outside the budget and planning horizon. This means decision-makers may not fully take into account the cost to government of such commitments. Contingent liabilities are especially prone to these problems;
- Risks associated with liabilities for the government need to be proactively managed over the lifetime of the project to achieve value for money;
- Uncertain payment obligations arising from contingent liabilities expose the government to fiscal risk that can create budgetary uncertainty and put the public debt on an unsustainable path…
- …in turn creating uncertainty among private partners as to whether the government will be able to honour its commitments, which can undermine the value for money created by allocating risks well.

A well-designed system for managing the liabilities of PPP projects can help address each of these challenges: ensuring government decision-makers take careful account of the potential fiscal impact of liabilities while ensuring the government is able to pay when needed, and in turn improving the credibility of the government's commitments.

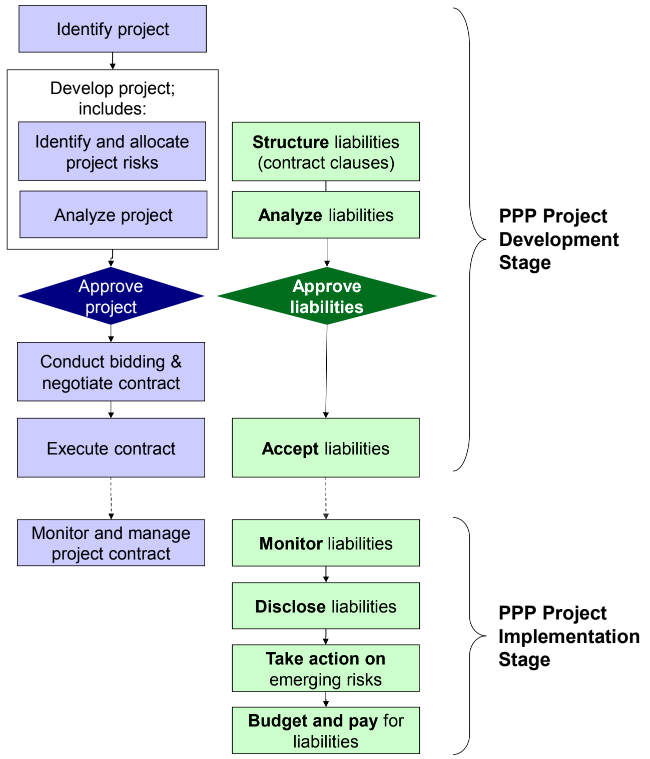
3.3 Functions to be undertaken

Managing and controlling liabilities takes place in all phases of PPP development, approval, and implementation processes.

The functions to be undertaken are shown in Figure 3.1, in the context of the broader PPP project development and implementation process.

It is important to note that while these functions are shown alongside the PPP lifecycle, they are an integral part of the PPP project development process and should be embedded within the overarching PPP Policy and related guidelines.

Figure 3.1: Functional Components of Managing Liabilities


Identify project
Develop project; includes:
Identify and allocate project risks
Analyze project
Approve project
Conduct bidding & negotiate contract
Execute contract
Monitor and manage project contract
Structure liabilities (contract clauses)
Analyze liabilities
Approve liabilities
Accept liabilities
Monitor liabilities
Disclose liabilities
Take action on emerging risks
Budget and pay for liabilities
PPP Project Development Stage
PPP Project Implementation Stage

Governments should clearly allocate responsibility for performing the recommended functions. This requires an appropriate institutional structure that will likely involve at least the government agency or corporation that is the PPP IA and the Financial Bureau and other stakeholders such as the Development and Reform Commission and other agencies responsible for municipal construction and planning.

In Table 3.1 we detail the specific functions that need to be undertaken to manage and mitigate contingent liabilities during the PPP project lifecycle.

Table 3.1: Functions to manage liabilities

Function	Objective	Notes
Preparing	To develop a project design that will be bankable and ensure that the risks the government will bear are consistent with good risk allocation principles, borne at the lowest cost and with minimal fiscal impact.	Project feasibility studies and implementation plans should consider the principles for allocating risk in a PPP, in line with international best practice, risks should generally be borne by the party best able to manage it at minimum cost.
Analysing	To inform decision making when the project is structured and approved, and provide a basis for monitoring and budgeting for liabilities.	Fiscal risk assessments and other tools for analysing liabilities will help ensure decision makers understand

		the expected cost and fiscal risk they are accepting when approving a PPP project. It will also improve how PPPs are structured, and provide useful information when monitoring and managing contingent liabilities once a PPP has been executed. Good analysis is also critical when negotiating contract terms with the social capital sector.
Approving	To ensure the use of government resources in the form of liabilities is focused on policy priorities; represents value for money; and is consistent with good fiscal management.	Because accepting liabilities under PPP projects uses government resources, the liabilities—along with all other forms of financial support—should be centrally approved to ensure that PPPs are focused on the government's policy priorities, represents value for money, and are consistent with good fiscal management.
Accepting	To clarify the government's commitment to its liability obligations, and to ensure the executed contract is consistent with earlier analysis and approval.	Accepting liabilities may involve the government executing formal instruments such as issuing debt, implementation agreements, performance undertakings and the like all with the purpose of the government guaranteeing that the IA will honour its obligations and commitments.
Monitoring	To provide information needed to disclose, act on emerging issues and, if necessary, budget for liabilities.	The government needs to collect and monitor information through information platforms and other means that will help it track its exposure to fiscal risk from year to year, and improve its ability to take action to reduce the cost or likelihood of an event triggering a payment occurring should risks emerge.
Budgeting &	To ensure resources are available to	A well-defined system for

Paying	make payments promptly when required—improving credibility and clarity as to how costs of liabilities will be borne, and mitigating the fiscal impact.	budgeting and paying for liabilities will ensure the government has the resources available to meet its obligations and mitigate the fiscal or budgetary impact of contingent liabilities. By doing so, the government will also improve the social capital sector's confidence in the government's commitment.
Disclosing	To improve accountability for decision-makers, and increase transparency of the government's commitments to third parties (such as credit agencies and lenders).	Reporting on exposure to liabilities through the budget and government accounts will increase transparency and improve the accuracy and completeness of information available to external parties. This avoids external parties such as lenders and credit agencies, who are likely to take a cautious approach, having to guesstimate exposure when assessing creditworthiness, for example, for defining a credit rating
Mitigating	To help reduce the cost to government of bearing contingent liabilities by reducing the likelihood or cost of those liabilities realizing.	Beyond simply monitoring exposure to contingent liabilities from PPP projects, the government should actively manage that exposure where possible, by identifying and taking action on emerging issues. Taking early action can help reduce the cost to government of bearing contingent liabilities. Acting to mitigate risk can also help to keep decision makers, regulatory bodies, and the private party accountable and, in turn, improve the credibility of the government's guarantees.

4 Budgeting and Paying for Liabilities

The government should implement a systematic process to budget and pay for liabilities. Such a process will strengthen incentives within government and provide the private proponent with a clear and credible message that the government will meet its obligations.

More specifically, effective policies to budget and pay for liabilities can help to:

- Incentivize decision-makers to accept the right liabilities, by making it clear who will be responsible for meeting the cost of liabilities;
- Improve the credibility of the government's commitments, by making clear the process and timeline with which the social capital partner will be paid;
- Reduce the adverse fiscal impact of needing to make a payment, by reducing the need for in-year budget cuts or overall expenditure shocks to accommodate the sudden need for an unexpected payment.

Contingent liabilities can be especially challenging. While managing contingent liabilities effectively can reduce the cost or likelihood of needing to make payments, it needs to be recognized that some contingent liabilities will be realized and payments will inevitably be required.

The crystallisation of a contingent liability is an unpredictable event. This is because by definition, a contingent liability only occurs if a future event—not wholly controlled by the entity—occurs.

This uncertainty creates real issues for governments to have the fiscal ability and flexibility to meet payments of contingent liabilities when they crystallise.

This uncertainty also means that because contingent liabilities payment may arise unexpectedly during a fiscal year and thus are unlikely to a be able to be reflected in the annual budget, as for other types of government expenditures. For this reason, the resources to make payment may not be immediately available.

There are a number of options to enable reliable payment of PPP liabilities:

- Budgeting for payments that are likely to occur in the forthcoming year;
- Structuring contingent liabilities to reduce the need for unexpected payments, for example making termination payments payable (with interest) sometime after actual termination to allow for the payment to be included in a budget cycle;
- Requiring contracting authorities or the government generally to set aside funds in advance against committed future payments, or in the case of contingent liabilities expected payments, in some kind of provision or fund; or
- Creating budget flexibility to make unexpected payments when required.

Broadly these options mean that liabilities are paid out of the government's general operating budget or some type of provision or funded reserve.

Establishing a Contingent Liability Fund (CLF) is one option. It provides a mechanism to improve the credibility of the government's PPP program by providing a source of funds for contingent liability payments and through disclosure of the likely magnitude of contingent liabilities. Depending on the option chosen for a CLF it can also provide an important monitoring and management mechanism.

5 Disclosing Liabilities

The PPP project libraries, list of demonstration projects, and PPP information platforms of the National Development and Reform Commission and the Ministry of Finance provide for the public declaration of key project data.[1] They provide for example information on the project name, location, investment, sector and industry, type of PPP, current Status, revenue source, key dates, and details on the partners to the PPP.

The management of government liabilities requires additional information on the fiscal liabilities. A template for the declaration of fiscal liabilities is provided in Appendix A. This template would complement those already used to provide key project data.

Completion of such a template would provide the data required for an annual, summary report on the government's liabilities to PPPs. An example of such a report is provided by HM Treasury's annual report on the United Kingdom's Private Finance Initiative.[2]

Such an annual report could provide information on, among other items, the: total portfolio of ongoing PPPs, showing the number of projects by implementing agency, and their expected capital costs; projects that have reached financial close in the last 12 months, showing project name, implementing agency, date of financial close, and capital costs; projects under procurement, showing project name, implementing agency, and capital costs; estimated, future government direct and contingent liabilities by year; and the present value of future government direct and contingent liabilities by implementing agency.

[1] See for example http://www.sdpc.gov.cn/gzdt/201505/t20150525_693171.html, http://www.cpppc.org/news/2666 and http://www.cpppc.org/bmgfxwj/2388.jhtml

[2] https://www.gov.uk/government/publications/private-finance-initiative-projects-2014-summary-data

6 Accounting for PPP liabilities

As a basic rule, International Accounting Standards (IAS 37) provide that PPP assets are classified in the social capital sector's balance sheet and not on the government's balance sheet. This occurs if the following conditions are met:

- the social capital sector bears the construction risks covering events like late delivery, respect of specifications and additional costs
- the social capital sector bears at least one of either operating risk or demand risk. Operating risk covers the volume and quality of output (performance of the social capital sector), while demand risk covers the variability of demand—that is effective use by end-users and revenue or payments that vary with demand. In some cases, demand risk may be shared between the government and social capital sector partner; and
- that the risks taken on by the social capital sector are significant and material.

A matching basic rule is that the direct liabilities from a PPP—for example availability payments—will be recorded in the government's accounts as an annual operating expense. They are recorded in the same manner as any other expense accrued on a periodic basis. Hence accounting for direct liabilities is straightforward.

Direct liabilities are treated differently in the rare situation where there has been inadequate risk transfer to the social capital sector through the PPP. In such circumstances, international accounting standards require that direct liabilities of a PPP be recognised in the government's balance sheet as both a liability and a corresponding asset. If the risk transfer is inadequate, the PPP becomes akin to a finance lease. International accounting standards require both the assets and liabilities of a finance lease and hence such a PPP to be recorded on the government balance sheet.

Accounting for contingent liabilities is more difficult but can be made manageable:

- An annual estimate of the likely magnitude and probability of future contingent liabilities becoming direct liabilities is made and compared to the previous Annual estimate. The difference—positive if the estimated liability increases—is then recorded in the budget and annual accounts as an expense
- In the event that a contingent liability crystallises—that is becomes unconditionally payable—then the payment is made from the provision, thus reducing the level of the provision in the balance sheet; and
- If the payment is greater than the balance in the provision, then the excess becomes an expense in the annual accounts.

The formal accounting entries for a CLF are summarized in Table 6.1.

If a PPP is akin to a finance lease—that is there is insufficient risk transfer for the PPP to be considered "off balance sheet"—then there are no contingent liabilities. This is because the liability for the PPP recorded on the balance sheet is the net present value of the future cash outflows for the government to meet the direct liabilities. Given that in the event of termination, any termination payment would be materially the same magnitude as the NPV of future cash flows, there are no additional liabilities to be recorded.

Table 6.1: Accounting for contingent liabilities in a CLF

Action	Accounting Impact	Note
Annual Fund Allocation (the difference between the estimated direct liability between two reporting dates)	DR Expenses (annual contribution)	Increases expenditure, thus reducing other expenditure for a given overall expenditure limit
	CR Liabilities (the CLF)	Creates a reserve against which payments can be made
Payment from Fund (payment < provision)	DR Liabilities (the CLF)	Reduces liabilities
	CR Cash	Reduces cash or increases debt
Payment from Fund (payment > provision)	DR Liabilities (the CLF)	Reduces liabilities
	DR Expenses (one off expense for the balance)	Increases expenditure
	CR Cash	Reduces cash or increases debt

Appendix A: Fiscal Liability Template

				Year (million CNY)														
Project	Feature	Description of liability	Total (present value in million CNY)	16	17	18	19	20	21	22	22	23	24	25	26	27	28	…
Project name																		
	Project investment																	
	Direct liabilities																	
		Direct liability 1																
		Direct liability 2																
		…..																
		Direct liability *n*																
		Sub-total																
	Contingent liabilities																	
		Contingent liability 1																
		Contingent liability 2																
		…..																
		Contingent liability *n*																
		Sub-total																
	Total liabilities																	

Notes:
Additional explanation of the individual liabilities

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